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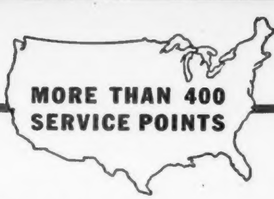

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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What Credit Men Expect from Accountants in Bankruptcy Proceedings

By MORTIMER J. DAVIS

I KNOW you came here tonight to hear Referee Kurtz, not me. In this program I am like the "curtain-raiser" in the old vaudeville days: the animal act, or the acrobats, who opened the show.

> MORTIMER J. DAVIS has recently become Executive Manager of the New York Credit Men's Association, after having served for some time as Assistant Executive Manager.
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> From 1917 to 1925, he was a Special Agent of the Federal Bureau of Investigation. In 1925, he became the Assistant Director of the Fraud Prevention Department of the National Association of Credit Men. In 1928, he was transferred to the New York Credit Men's Association where he became Manager and Assistant Secretary of the New York Credit Men's Adjustment Bureau, Inc.
>
> Mr. Davis today is considered one of the nation's foremost lay authorities on all phases of bankruptcies, reorganizations and adjustment procedures. He is a member of the National Bankruptcy Conference and has lectured on these subjects in many schools, businessmen's organizations, and professional societies.
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> This address was delivered by Mr. Davis on May 22, 1947, before a technical meeting held under the auspices of the Society's Committee on Bankruptcy Procedure.

I would like to reminisce a bit about accountancy so far as it relates to bankruptcies and insolvencies. Prior to World War I—and I go back that far, believe it or not—the accountant wasn't a very important figure in bankruptcy. Life was simple, cases were simple, everybody was presumed to be honest; if people weren't, it was possible to "get away" with a fraud in bankruptcy if one had been perpetrated.

Some years back we added a novel act, called the Income Tax Law, to our statute books and I think that for the first time people really become tax-conscious and accountant-conscious. And about that time, cooperation between credit men and accountants began. Not that it hadn't existed before, but theretofore it was hit-or-miss. The two professions now found that they had something more in common, and we had the beginning of the close cooperation between accountants and credit men which exists today.

In 1920, as some of you here will remember, there was a very bad financial collapse. There were numerous bankruptcies. In the textile line there was a tremendous drop, overnight, in silk prices. The accountant became a little more important. The credit man began to realize that he needed more audits. We began to hear more about certified statements and quicker information

about the inventories and operations of customers.

From 1923 to 1929 we had what is now referred to as a "boom" in this country. New companies were forming. Quicker information was needed by credit men. We heard talk, increasingly then, of monthly trial balances. The old annual audit began to be a thing of the past; they wanted semiannual audits, quarterly audits—yes, even daily information. I know of some accounting offices, back in those days, which had special telephone connections in their switchboards to answer credit men who had to make spot decisions.

Who does not remember the stock market collapse and depression in 1929, which ran practically through 1938, with the flood of failures that followed? I believe that, in a bankruptcy sense, it was in this period that the accountant really "emerged" in bankruptcy. In that period I can hardly remember a case of any size, where there was not some need, no matter how small, for the services of an accountant. In that period, you will also remember, we had a proceeding under Section 77-B for the reorganization of corporations and one under Section 74 for the settlement of affairs of copartners and individuals—and of course we had a flood of liquidations. I worked all through that period and when I say the accountant "emerged" in bankruptcy, I really mean that the business world took cognizance of the fact that times had changed and that there was greater need, in the opinion of credit executives, than ever before for information regarding bankrupts: the kind of information that could only be obtained from books of record.

World War II, of course, followed this depression, as we all know, and I like to refer to this period as an "accountants' paradise": taxes, renegotiations, OPA, corporate and partnership changes, inventories, government controls. What a grand time you fellows had! There weren't any bankruptcies, to talk about, in that period.

And now we are in what we call the post-war period. You heard what your Chairman said about predictions. Well, the predictions are beginning to come true. Our Adjustment Bureau, dormant for five or six years, has begun to shake off the dust; we are really working. We have cases coming in. The Referees in Bankruptcy are busy again. And, as I view this thing (and it is, of course, my personal viewpont) I don't see how any case of any size can really be administered intelligently, or any solution reached without the aid of an accountant somewhere along the line and, of course, preferably a Certified Public Accountant, because our Association, in its reorganization work, will not engage anyone but Certified Public Accountants.

I don't see how, in this post-war period that we are talking about—and I think we have only entered upon this difficult period—we can brush aside or minimize the important part the accountant is playing to a much greater degree than ever before.

Bankruptcy matters, as I classify them, consist principally of cases which come under either Chapter X or Chapter XI, and cases which go into what we call straight bankruptcy or liquidation. I assume that everybody here knows something about Chapters X and XI; if not, Referee Kurtz will certainly tell you. There is an immediate distinction necessary between proceedings under Chapters X and XI, as against those involving liquidation. In order to lead up to what I want to say about this and the work of the accountant, I should like to put it to you in this fashion: In Chapter X or XI matters, we have situations wherein we are dealing with what is in the estate. We have a factual situation in which we try to patch up a sick business and see if it can't be revived and restored. On the other hand, we view liquidations as a hunt for assets in connection with the winding up of a business to the best advantages of its creditors.

Chapter X and Chapter XI cases are

what we call "continuation cases". Invariably the debtor is continued in possession of the business. In infrequent cases the Court will, for good reason, appoint a receiver or a trustee, but I think you will find that the records show that in the large percentage of cases, debtors are permitted, for good and sufficient reasons, to remain in possession and operation of the business assets.

Now our job, in those cases, is to try and organize the creditors' interests as intelligently as we can. In Chapter X cases, we have to consider the rights of secured creditors, stockholders, bondholders, etc.; whereas only the rights of unsecured creditors are affected under Chapter XI. Our concern is with the rights of the unsecured creditors and their organization for their own protection, with the assistance of the Court.

In approaching these cases from the standpoint of what the credit man expects from the accountant, I have listed a number of items:

First and foremost, we want a balance sheet, or what is known in Chapter XI as "a statement of affairs". That, I suppose, is basic to you accountants. And, of course, we are also interested in operations, which means a profit and loss statement.

In these Chapter X and Chapter XI cases, the question of existing contracts frequently enters into the picture; and don't misunderstand me if I get into any subjects that appears to be partially legal. That phase of the work which is legal we certainly believe belongs to the attorney; but there are so many of these cases where the attorney and the accountant must work shoulder-to-shoulder that, when I include them under the heading of what we would like the accountant to report, I am not reflecting on or minimizing the importance of the attorney in these matters.

In these reorganization cases we like accountants to point out, in their own professional way, the weak spots in the operation of the business, such as the unprofitable items or departments.

We would very much like to have you indicate or state clearly in your reports some appraisal of the management's ability.

We would like you to indicate what you believe to be the possible future earning power of the business, and that is particularly applicable in Chapter X cases where so much in the plan is predicated upon what the earning power is; especially when the plan may involve the issuance of stock, debentures and bonds.

We are intensely interested in the tax situation. For example, we like to know whether the debtor has been living on the Government's money (even though he may have paid it to creditors) because clearly you can see that the amount of taxes eventually assessed has a great effect upon the dividends which the unsecured creditors will get.

In many of these cases you will be called upon to assist in the preparation of budgets—budgets which have to do with the feasibility and possibility of working out plans and arrangements of reorganization.

And you will find, frequently, that you will be called in by counsel and by creditors to assist in the preparation of the very plan itself.

There is a very clear demarkation between the work of the accountant and that of the lawyer. But I am going to be very frank to say that, for whatever the reason, the businessmen and the credit men somehow or other lean and look more toward the accountant for business advice in these cases than they do to the lawyer. They are happy to have the lawyer resolve the legal problems, but if you accountants don't take advantage of any ability you have in analyzing these business problems in Chapters X or XI matters, and voice opinions and suggestions that have to do with the welfare of the business (such as: is it possible to operate profitably, or otherwise, or even if your advice happens to indicate the business

ought to be liquidated), I think you are leaving out something that the average business or credit man would very much like to have from you.

I know that you are wondering how you can do all this on the fees that you get in these cases. I'm sure Referee Kurtz is going to straighten us all out on that subject.

In the straight bankruptcy case, the liquidation case, I know that a lot of this discussion is really "old stuff" to many here assembled and perhaps I am addressing my remarks to just a limited few who haven't had the extensive experience of some of those who are sitting in this room. For their benefit, I shall comment on some of this perhaps very elementary and fundamental information or advice.

In a liquidation case (no plan, no arrangement) we are involved in a hunt for assets. To us that presents an entirely different approach, an entirely different picture. Again, we want a balance sheet, because the average credit man who is "stuck" wants to have some vague idea of what he might get in the way of assets. Even though we know that the balance sheet that you draw off from the books is subject to many changes along the liquidation lane, still we like to have it. We are also very much interested in what the probable tax bill will be.

You, as accountants in these liquidation cases, have a lot to do in revealing information that may result in actions being filed by attorneys in connection with preferences, transfers, the disappearance or concealment of assets or the inability of a bankrupt to account for the assets, which sometimes results in a "turn-over" proceeding.

Now I think that it is obvious, or should be, that an accountant seeking engagements in cases of this kind, should know something about the bankruptcy law, especially if he has to prepare this information and more especially if, as usually happens when these issues are fought out, he becomes the amanuensis of the attorney sitting at his elbow and supplying him with that vital information which he needs to prosecute these actions successfully.

I remember a "turn-over" case in the textile line that was lost because the accountant forgot to take into his calculations linings that were used in the garments being manufactured; when the bankrupt put that in as part of the defense, it blew up the entire "turn-over" proceeding.

You have to know how to recognize a preference, even though you may have an attorney there to tell you what it is. You have to know a concealment when you see it, and you have to know what is involved and required in the "turn-over" proceeding. Referee Kurtz will probably tell you that the hearing and determination of a "turn-over" proceeding is undoubtedly the most technical, the most difficult and onerous part of a Referee's job.

We like to know what moneys have been withdrawn by the bankrupts. We'd like to know, if you can tell us, why the business failed. You might say, "Why?" Out of these various things, reported by you accountants, we frequently draw valuable lessons. You may not know it, but many of your reports are used as case histories. I don't think that I am violating any secret in telling you that, in hundreds of cases that were handled through the the Adjustment Bureau of the New York Credit Men's Association, the books of record, after the estate was closed, were turned over to the auditing laboratory at Columbia University and were used by the students there for case-work in connection with their training as auditors. All your comments indicating why the business failed are taken very seriously by many businessmen and credit men.

I'd like to throw in here some of my own suggestions about the preparation of reports in these bankrupt and insolvent estates, and I assure you that it represents only my own opinion, for I haven't been sent here by an organization with a message of this kind.

To me, fancy reports with beautiful covers on very expensive paper have never been impressive. They have never meant a thing to me. I have gained as much from an accountant who reported from his work sheets as I have from a very big, thick, beautifully bound report which the committee took home and didn't read because it was too voluminous.

I have seen some of the finest reports rendered by accountants in these proceedings completely ruined by a total inability on the part of the accountant to explain the report. I have often wondered why the accounting schools haven't made it a requirement that every accountant take a course in elocution. To me, the ability to deliver and explain a report before a body of credit men, or to get on the stand and testify, is most vital. I have been annoyed no end—and I know credit men have been annoyed no end—at the type of accountant who comes into a meeting with his voluminious report and proceeds to read it, word-by-word, starting with the date! What a wonderful gift it is to be able to get right down to the meat of a report and explain it in simple, non-technical language.

I suppose businessmen are always in a hurry. I often wonder what they do with all the time they save. But I assure you it is a major annoyance to have an accountant come in and attempt to read such a voluminous report *verbatim*.

Now, what to stress? What to bring out in your report?

A great deal depends, in my opinion, on your knowing the particular trade involved and what particular type of creditor you are serving. I say, very frankly, that there is a wide difference between what management in different types of industries wants by way of information. I take my first lesson from the textile industry with which I am probably most familiar, and where those who practice know that commission houses and textile mills are vitally interested in the moral standing, character and conduct of the bankrupt. They want to know whether the statement issued is false or true. They want to know if there is a concealment. They want to know if there were preferences or fraudulent transfers. I would say that they are often more interested in that than in the value of the assets as against the liabilities.

By way of contrast, I might pick another industry (not to malign them) where you have more of a sales psychology among credit men. They may say: "We know he's probably a crook and it's too bad he failed; but how can we get this thing back on its feet? What can we get out of it and how quickly?" There, in many cases, you may find out that digging into the moral aspect of the situation might be a waste of time. I don't want to discourage you in that; I think it is your duty to do it in every case. I'm merely trying to make a very quick distinction with respect to what might or should be stressed, depending on the type of situation involved.

I have been in cases where the creditors didn't even want an accountant. "How quickly can we get some money of this thing? Never mind the books; when can you pay us? How long will it take? Five years? All right, five years."

I have been in cases where they just said, "Oh, give us a balance sheet; that's all we want. We don't want to know about profit and loss." You have to know the industry you're serving. You have to know the type of creditor who has engaged you. You have to know what the requirements of the case are.

We like accountants to appraise the value of assets—and here my friend Referee Kurtz may differ with me. We know that, in the court, there is a procedure and rule under which official appraisers are appointed, and we have no objection. But we also value very highly the professional ability of accountants to estimate the value of assets in many cases. We have found, believe it or not, that your opinion (especially in lines with which you are most fam-

iliar) as to the probable value of inventories, the probable liquidation value of accounts receivable, and even furniture and fixtures, comes pretty close to being the right answer. We like plenty of verbal comments and, sometimes, that comprises the real report, where the balance sheet is very complex. We like opinions from accountants; we like suggestions; and, as I said before, we like reasons and causes.

I have seen too many of the "shrinking violet" type of accountant brought into these engagements, who do nothing but merely submit their report, perhaps read it, and leave the creditors very flat! Please don't be afraid, so far as credit men are concerned, to speak up. We do value your opinion and suggestions because we know how expert many of you men have become in your respective lines and in your professional work. I might almost say that if you are not equipped to take these jobs, you should not begin them. I wonder, sometimes, why some accountants go out after these cases at all. But I suppose there are reasons far beyond the value of the compensation, frequently, that make accountants feel they want this type of work.

In your balance sheets—and this, again, is my personal comment—the credit men we represent like this type of presentation: We like a column in which the book assets are shown and, right next to it, we like another column in which you list what you consider to be the possible or fair realizable value of those assets. And that goes for every asset that you are in a position to evaluate.

I have seen reports where there is a big list of assets and a total, together with a complete list of liabilities; and then, by way of explanation, we were told that, of course, this asset isn't an asset for general creditors because there is an offsetting liability or contra item on the other side. Well, we like a situation like that set up on the asset side so that we can quickly perceive the entire picture in one viewing. Deduct such a liability, if you please, right from the asset.

Another suggestion which you might care to follow, if you get called into these cases: On the liabilities side there may be listed anywhere from one to fifteen items of taxes, wages, and other types of preferred or priority claims. From an accounting standpoint, I suppose that this is correct procedure; but a number of accountants have adopted the practice of taking those preferred and priority liabilities as deductions from the asset side—from that column called "Net Realizable."

Now, what is the effect of this? A businessman or a credit man looking at that balance sheet, knows exactly, and without fooling himself, what he has to look to, what he has to work with, and what he can hope to get, although it may not be good accounting practice. Somebody may say, "You shouldn't do that. The debtor will learn of it and, knowing what the realizable assets are, he will be able to play this off against you in a settlement case." Don't worry about what the assets are. The debtors know what they have, and nothing that you can put into that report, in that manner, will alter the case; but it does help the business man who isn't an accountant actually to see what his position is as a creditor.

I have indicated that fraud and crime sometimes enter into these cases. Credit men generally like to know if the fellow they're dealing with is a crook. They may not always take action. The Trustee in bankruptcy is, however, required by law to report any crime he discovers to the district attorney.

I had the privilege, the honor of working with a committee from your Society in trying to obtain a revision of the United States Supreme Court rules regarding the retention of accountants and their compensation and, in the brief that was submitted, we listed two and one-half pages of things that an accountant is, or may be, expected to do in bankruptcy engagements. I am not going to bore you by reading them.

Anybody can see them, if he wants. But, after reading this list of engagements—this knowledge that you're supposed to have—if you, yourself, don't come to the conclusion that bankruptcy accounting today is something of a specialty, then I miss my guess.

That doesn't mean every accountant who gets a certificate isn't capable of going in, analyzing a set of books and preparing a balance sheet; that is only the beginning. I said to you at the outset and I repeat: the work of the accountant has increased to such an extent in these matters and the necessity for his retention is so much greater today than it ever was before that, in my opinion, bankruptcy accounting has definitely become a specialty.

Now, to sum up all this: what does the credit man expect from the accountant? He expects that the accountant is going to do about three times more than he's paid for. I am not going to comment on the fee situation nor the method of compensating accountants in bankruptcy matters. Referee Kurtz tells me that he will dare to touch upon it.

We look upon accounting work in these estates as something in the nature almost of a public service, and that is also true of much legal work. It is true with respect to the work of many receivers and of many trustees. The compensation of those officials is all too frequently far less than they are entitled to, and they become somewhat of a public servant when they undertake to serve in those cases.

We know, on the other hand, that over the years, many accountants have built up something of a reputation for themselves by being willing to come into these cases and take some of the bad ones along with the hope that they will get some of the good. We know that, as a result of taking that type of work for which you haven't been properly compensated, many of you have made contacts and, from those contacts, have gotten new clients. We know, without your telling us, that this work was one of the things by means of which many accounting firms built up practices. You'd be surprised to learn how many clients accountants have obtained from debtors whose businesses were reorganized under Chapters X and XI.

Let me conclude by saying this: whether you believe it or not, the credit man is the best friend the accountants ever had. I sometimes wonder whether it was the accountant who made the credit man important, or vice versa; but I do know that the credit men—the type who belong to our Association—have been and still are great boosters of Certified Public Accountants.

I know of one industry in this city in which accountants were rarely retained, wherein the credit man entrenched the C.P.A. I know it was the credit man in that industry who, by his insistence upon quarterly — not semi-annual — audits and monthly trial balances, on the taking of inventories by accountant, on tax information, on verification and preparation of financial statements, caused the client to revise his ideas with respect to the compensation that the accountant was entitled to receive.

We credit men and your Society have marched together, shoulder-to-shoulder, for fifty years—I think our Association is about two or three years older than yours. Our relations are most cordial. I hope they will always remain so.

A Bankruptcy Referee Speaks Informally to the Accountant on Fees

By Irwin Kurtz

I thought I would talk to you informally and that I would make this talk a very short one and then answer questions. I think you will get more out of that procedure and so will I. I know that the subject you would like to hear me discuss is accountants' fees, and I am going to be very blunt and very frank with you on that subject. Then you can ask me all the questions you please in relations to fees or any other matter.

First of all, you must understand the position we referees are in. Judge Knox gave me instruction in relation to fees fifteen years ago, just about this time of year, before I was sworn in, and I have never forgotten them; they are these: "Don't forget you are there representing creditors. This estate is not exclusively for the benefit of lawyers, accountants, receivers and trustees; the creditor is entitled to something at the finish of the case. Even if nobody objects to a fee, it is your duty to see to it that the creditors' rights are protected." In my humble way—I do not know whether I've succeeded or not—I have tried to follow that admonition.

It isn't pleasant to cut fees; I do not like it. I know lawyers and accountants have to live—that their expenses have gone up. When I was practicing law I used to be able to hire a fairly decent office for $50; today I'm informed it would cost me from $150 to $250 for the office, if I could get it. I used to be able to get an efficient stenographer for $18 a week; today, they look askance at you if you offer $50 a week. I know the cost of stationery has gone up, too. On the other hand, in recommending fees we are bound by the bread we have in the basket: we cannot hand out more than is there; and, if you could see those applications for allowances coming in—particularly in these Chapter X matters where there are ten or fifteen committees, not one as there is in Chapter XI—with a million-and-a-half in the estate, they'll ask for eight or ten million dollars in these applications. And the unfortunate thing is that all the poor creditors ever know is that they get a notice of the fact that eight million dollars is being asked for —they never get a notice of the fact that the Court has chopped the applications down to $600,000.

> The Honorable Irwin Kurtz has been a Referee in Bankruptcy since July 1, 1932, and has handled thousands of bankruptcy matters including many large and important chain and realty corporations.
>
> Mr. Kurtz was President of the National Association of Referees in Bankruptcy for three years. He has written many articles on various aspects of Bankruptcy for several publications.

The first thing I want to impress upon you is this: don't ask for more than the traffic will allow. If you have a case that only has $750 in it, don't ask for $1,000 for your fee. You know you can't get it, and it only makes it look bad when the notice goes out to creditors. As one creditor wrote to me in the old days of 77(b): "What is a 77(b)? Is it a hive around which accountants and lawyers gather to suck all the honey, leaving an empty hive for the creditors?"—and he was right. Don't ask for more than you can expect to get.

Now I know the fight your Society has been making for a change in General Order 45 of the Supreme Court. Let's look at the language of "45". It reads:

"No accountant shall be employed by a receiver, trustee, or debtor in possession, except upon an order of the Court expressly fixing the amount of the compensation or the rate or measure thereof."

Now I emphasize "or the rate or measure thereof". What does that mean? It means that a referee would have the right, if he wanted to, to fix the compensation of the accountant at so much per day. That is the rate. Now, the measure: What can that be? The measure means this, as I interpret it —and I have used it as an index in some cases: that sometimes a lawyer and an accountant will come to me and say, "There is very little in this estate —merely $750—but we think that, by a proper inspection of books in this case and by a lot of work, we can dig out assets."

I say, "All right, fine! You dig out assets and you ought to be compensated." It is akin to the engagement of a lawyer on a contingency basis. I have entered orders retaining accountants to the effect that if they produced results, I would give them X dollars; otherwise, they would get no compensation at all. That's what "measure" means.

I know that the objections of accountants have been that when they enter a case, they don't know how much work there is going to be in it. There are two answers to that.

Suppose I'm running a shoe store. I need an accountant and I go to you and say, "I want you to do the general accounting and tax work for my store. I want to know how much you are going to charge." You're able to tell me, aren't you?

With your experience in bankruptcy matters, why shouldn't you be able to tell a trustee, with a fair chance of guessing right, about how much your ceiling ought to be in a bankruptcy matter. But, assuming that you can't, there is still another way.

There is nothing to prevent me from increasing the compensation ceiling, and I do. In a proper case, the referee has the power, on an *ex parte* application, immediately to increase the amount of the accountant's ceiling.

The answer from the accountants is, "But some referees don't do it." Well, there is no law that can make perfect men all around the country; I don't care how you amend it. You can't make perfection in referees; we're human beings. When I became a referee, we had 550. The last count I had was 350. On July 1, when we all go on salary, the number will be cut to 165: 49 full-time referees, of which there will be 7 in Greater New York, and 116 part-time referees around the country.

Now there will be fewer of us to deal with in the future, and the thought back of this bill was, if possible, to make all referees serve on a full-time basis, thus decreasing the number and making a referee more conversant with the subject of bankruptcy. Very frankly, in my job as President of the National Association of Referees, I have come across referees who probably never read the Bankruptcy Act and who didn't know a thing about it, much to my amazement!

You are not going to get perfection, but you're going to get 49 full-time referees. There are four provided in Manhattan and the Bronx, two in Brooklyn, one in Queens, covering Nassau and Suffolk. The referees in Brooklyn will cover Staten Island, where there is very little bankruptcy business. There will be two in Newark, covering almost the whole of New Jersey, and one covering the whole State of Connecticut.

I say that the criticism I have heard from accountants—that you can't get referees out-of-town to act on these increases—will be largely dissipated by reason of the fact that you have fewer referees to deal with. They will be more conversant with bankruptcy procedure.

Now, how do we arrive at the amount of fee to give an accountant? I know that is in your minds. You may

think that it is a pure guess on our part: attorneys' and accountants' fees. That just isn't so.

Take my own experience. A case is finished and the final meeting to consider fees is before me. I have an estate of $1,200. I'm taking an actual case now. I find that $1,700 has been requested by attorneys and accountants. It is physically impossible to pay such fees. You can't ask the referee to take $500 out of his pocket and give it to you.

I don't enjoy fee cutting any more than you do, but I have to cut my cloth to the pattern. What do I do? I look first and see what creditors there are. I see: Taxes—$8,000. I look and see the poor creditor body behind the taxes—$20,000. I know, therefore, that I can't pay any money to general creditors. I try to be as liberal in that sort of a case as I can to attorney and accountants. If, on the other hand, there is a chance of paying a dividend to the general creditors, even though it is only one-half percent, I deem it my duty to try to do so. If there are any wage claims, I try to pay something on the wage claims; as you know, they come ahead of taxes.

Then, I go through the attorney's application, starting with the basic allowance of twice the trustee's fee. I start out thus: How much was there in the estate when it started—when the trustees came in? How much is in it now? That is not the sole criterion, however, because other results may have been accomplished, such as diminution of claims; reducing tax claims; etc. Then I go through the application and take the extraordinary work. I put that down, item by item. If the attorney brought $500 into the estate and if he did by bringing an action, then I put down so much—either 25% or 33% of the amount recovered, depending upon what he had to go through to get it. However, if he brought no action but just wrote a letter, I give him another and smaller amount: I think I allow for this service on a parity with the usual collection charge fee. After I get all these figures down, I round it off: maybe it's $150; I might make it $175, or I might reduce it a bit, depending on how much I have in the estate.

Now I do the same thing with the accountant. If I find that an accountant has done work resulting in a criminal indictment and so aids the district attorney, I always take into consideration the fact he has rendered that service and is entitled, in my opinion, to compensation because that is part of the case. It isn't always possible for us to give you all that you ask for, but we try to be fair and, if we are wrong, under the rules in our district you have a chance to appeal. We don't mind it if you get the judge to increase the amount that you claim is due you. But we really try, cognizant of our duty to the creditors, to give you a square deal.

Question: *The referee gave you some idea as to how he endeavors to fix the fees of accountants in the estates that are in liquidation. I would like to know what method he uses in determining accountants' fees in cases where a plan of arrangement has been consummated under Chapter XI.*

Answer: Let me say there are two classes of accountants in Chapter XI. One of them is the accountant for the debtor in possession and, sometimes, when the official committee comes into existence, the official committee has the right and the power to select its own accountant without an order from the Court. It is only a debtor in possession who must get an order from the Court.

Very often, the accountant for the debtor is also made the accountant for the committee; but that need not follow and you can have two separate accountants.

Now then, answering your question, where an accountant is retained by a committee, the accountant does not personally make an application to the

Court; the committee is the only one which can make that application. That is true, also, of the attorney's fee. The committee comes in and makes an application—and part of that application can be a recital of what the attorney did for the committee and a recital of what the accountant did for the committee. Then the committee comes in and says, "We would like $X to cover the work of our accountant and that of our attorney." That is one type.

Then the referee passes on it immediately, because one of the things you must do in Chapter XI is to pay over immediately all of the money which is to be paid for fees into a bank account; and one of the things that must be paid is the expenses of the committee, which includes the accountant's fee. So that, while you may not get as much as you would in a liquidation, you will get it quickly and not at the final meeting, which is sometimes two years off.

Now then, assuming you are the accountant for the debtor in possession, I must sign an order approving your appointment and I must set a ceiling or a measure of compensation on the amount that you are to get. In other words, supposing I set it at $10,000; you are bound by that ceiling.

Now I think that if an accounting firm were to come in to me on the matter that I fixed the ceiling at $10,000 and asked for less than $10,000, I would die of heart disease! What usually happens is that, no matter what the amount fixed in the ceiling order, the accountant always comes in and shows that he has performed at least $2,000 or $3,000 more, knowing that he can't get more than the amount of the ceiling.

In Chapter XI cases, I have to bear this in mind: there is no sense in reorganizing a company at all if you're going to bleed it white by taking all the red corpuscles of ready cash away from it. In other words, what I mean is this: the expenses, which are payable in cash, can't be so great as to deprive the debtor of all working capital. I bear that in mind.

In addition, I bear in mind the recommendation of the creditors. If the creditors are being paid a cash payment of 35¢ on the dollar, then the future of the business is none of the creditors' business; rather is it the debtor's business. But, as is the case in many of these proceedings, if they are being paid in notes or over a period of time, the creditors are greatly concerned about how much money is being paid for expenses in cash.

In cases where the debtor has made a cash offer to the creditors, I instruct that copies of these applications for allowances be served upon the debtor and I listen to him as to whether he thinks the amounts are proper. In cases where debts are being extended over a period and the rights of creditors are involved, I listen with great respect to the creditors' committee as to whether they think the amounts to be paid in the way of fees are proper.

I think that answers your question.

A Discussion of the Nature and Function of the Accounting Statements in Fiduciary Accounting

By Aaron Kurz, C.P.A.

Applicable Accounting Principles

Accounting concepts must be adjusted to serve the particular purposes for which they are invoked. Thus, from the accounting viewpoint, the object of business activity is the enhancement of capital through the earning of a profit. Therefore, a refinement of the fundamental equation, Assets minus Liabilities equal Capital, provides a satisfactory basis in terms of which all business transactions may be analyzed, financial condition determined and the success of the business activity measured. In fiduciary accounting, however, the concept is altogether different. A fiduciary is one who is entrusted with the care, custody and management of property for the benefit of others to whom he must be in a position to account for the faithful discharge of his duties. Clearly then, the accounting concept on which fiduciary accounting should be based, must be directed at recording all funds and property entrusted to the fiduciary which, in the aggregate, measure the extent of his accountability. Transactions in which such funds and property increase or decrease, directly affect the amount of his accountability. Stated in accounting terms, the fundamental equation in fiduciary accounting is:

Assets=Accountability

Fluctuations in the latter can then be recorded in accounts with appropriate titles indicating the nature of the cause of the change. Accountability so conceived must not be confused with business capital. Thus the payment of a debt does not affect capital in business accounting; however, in fiduciary accounting the payment of a debt does reduce the accountability of the fiduciary.

The Account of Proceedings and Schedules

The last phase of the fiduciary's administration of a decedent's estate, is the accounting proceeding. In the course of this proceeding, the fiduciary submits to the court and those interested in the estate, his account of proceedings, or account, as it is more generally known. The purposes of this proceeding are to settle the estate and to compensate and discharge the fiduciary. Obviously, these purposes cannot be satisfactorily accomplished without a full and orderly disclosure of the fiduciary's conduct of the affairs of the estate. The logical starting point is his initial accountability for the funds and property that came into his hands. This must be supplemented by a detailed recital of any increases and decreases therein, thereby arriving at the final amount of his accountability. The latter should be represented by a schedule of funds and property in his possession or under his control as of the last date included in his account of proceedings. The latter includes a caption, a recital of judisdictional facts, a description of the nature and content of each accounting schedule, a summary of the account, detailed schedules supporting

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each item in the summary and the affidavit of the accounting party. It is the function of the professional accountant to analyze all the fiduciary's transactions and to present them in the accounting schedules so as to constitute an orderly, clear and comprehensive report of the latter's conduct of the estate's affairs and the complete history of his accountability. The schedule forms used are generally supplied or determined by the court in which the proceeding is instituted. In this regard, the conservatism of the legal process has its impact on accounting practice, for innovations or departures from established practice are generally discouraged.

I shall discuss the composition of these accounting schedules in the order and with the letter designation currently used in the Surrogate's Court of New York County for an executor or trustee.

I shall prefix this discussion with the following general comments which are applicable to all the accounting schedules. Each schedule should begin with a proper title consisting of the name of the estate, schedule designation by letter and a description of its contents. Since the schedules are bound or stapled together at the top, it is desirable for convenience of reference to put the schedule letter and page number of the schedule at the bottom of each sheet of the account. Do not omit a schedule because there isn't any information to be submitted on it; prepare the schedule, insert the word "None" and have the schedule signed by the fiduciary. Each schedule should be signed at the end by the fiduciary, and the word "Accountant" should appear immediately under his signature. This term is not intended to signify that the fiduciary is a professional accountant; it merely indicates that in this proceeding he is seeking to account for his stewardship of the funds and property left in his care. If any questions arise which have legal implications, they should be referred for determination to the attorney for the fiduciary. The forms hereinafter presented should be adjusted where necessary to conform with the requirements of the facts in each particular case.

Principal Account

Schedule A "contains an itemized statement of all moneys and other property . . . belonging to the estate" which the fiduciary has received or over which he has control, together with any accrued income thereon to the date of death, all of which constitutes principal in his hands. This schedule lists the funds and property which in the aggregate measure the initial accountability of the fiduciary. Immediately under the caption of this schedule, it is well to have a condensed summary of the total amount and kind of each asset, followed by a detailed list of the individual items constituting each kind. Thus, the summary would list in totals the amounts of cash, stocks and accrued dividends, bonds and accrued interest, loans receivable and accrued interest, personal effects, etc. This should be followed, under separate captions, by detailed lists of bank accounts, stocks, bonds, etc. Each list should be arranged alphabetically and each item should contain sufficient information to identify clearly the specific asset. In the case of a decedent's estate, the inventory is valued, and accrued income computed, as at the date of death; in the case of a trust, it is valued as at the date of receipt. If the decedent had a margin account with a stock broker, a loan secured by collateral or real estate subject to a mortgage, the amount listed in this schedule in each case would be the net equity. This would be included in the base for the fiduciary's commission and constitute the amount of his initial accountability.

The following headings are suggested for the assets indicated:

For Stocks:

No. of shares	Name of Corporation	Class	Par	Inventory Value

For Bonds:

Face Amount	Name of Debtor	Interest Rate Type and Maturity	Inventory Value

SCHEDULE A-1 lists "increases derived from capital assets whether due to sale, liquidation, distribution or for any other reason." The total of this schedule represents an increase in accountability. When assets are distributed to legatees, their value at the date of distribution is the "amount realized". The inventory value of a security which has been disposed of, should not include the accrued income at the inventory date. The data in this schedule may be presented as follows:

Date of Transaction	Nature of Transaction and Description of Capital Asset	Amount Realized	Inventory Value	Increase

SCHEDULE B contains a statement of all decreases in the value of capital assets due to sale, liquidation, distribution, physical loss or damage or any other reason. The total of this schedule represents a decrease in accountability. The following columnar form is suggested for listing the data in this schedule:

Date of Transaction	Nature of Transaction and Description of Capital Asset	Amount Realized	Inventory Value	Decrease

SCHEDULE B-1 contains a statement of those capital assets which are not collectible with the reason therefor. The total of this schedule represents a decrease in accountability. It is not sufficient to state that a receivable is uncollectible; the schedule should reveal what steps were taken to collect and the reasons for the failure.

SCHEDULE C contains all administration, funeral and other necessary expenses which have been paid and which are chargeable to principal. The total of this schedule represents a decrease in accountability. Items should be grouped chronologically under each of the above headings with sub-totals stated for each group as well as a grand total for the entire schedule. By statute, funeral expenses include a reasonable charge for perpetual care of the decedent's burial lot, in addition to the other usual items for church services, a burial lot and a suitable monument. The information for each item should be presented in the following columnar form:

Date of Payment	To Whom Paid	Nature of Expenditure	Amount

SCHEDULE C-1 contains all unpaid claims for administration, funeral and other necessary expenses, together with a statement of the basis for each claim. This schedule is informational and does not form a part of the summary of the fiduciary's account since it does not affect his accountability. If an estate were unable to pay these claims in full, administration expenses would be preferred over funeral expenses.

SCHEDULE D contains a list of all claims of creditors presented to or known by the fiduciary with a statement as to whether any are preferred and, if so, the basis therefor. This schedule is also purely informational and does not form a part of the summary of the fiduciary's account which traces and measures his accountability.

SCHEDULE D-1 contains a list of the estate's judgment creditors, giving

names of the claimants, general nature of the claim, amount of judgment, name of the court in which rendered and date of entry. This schedule is also purely informational and does not affect accountability. In the event of an insolvent estate, judgments docketed and decrees entered against the deceased, not the fiduciary, while subordinate to administration and funeral expenses and taxes, are preferred, *inter alia*, in the order of priority of docketing, and take preference as a group over general creditors.

SCHEDULE D-2 contains an itemized statement of the personal claim of the fiduciary against the estate. This may be paid only if allowed by the court, after the fiduciary has submitted his proof. The salutary reason for this rule is obvious. This schedule is informational. Accountability will be ultimately affected only to the extent that the claim is allowed and paid.

SCHEDULE D-3 contains a statement of claims disputed or rejected by the fiduciary and his reasons therefor. Since such creditors must be duly notified of the accounting proceeding, they are assured of an opportunity to appear and prove their claims. This schedule is also informational. Unless such claims are approved and paid, the amount of the fiduciary's accountability is not reduced.

SCHEDULE E contains a statement of all creditors' claims which have been allowed and paid by the fiduciary. The total of this schedule represents a decrease in accountability. This information can be conveniently presented in the following columnar form:

Date of Payment	Name of Creditor	Nature of Claim	Amount Paid

SCHEDULE E-1 contains a statement of all creditors' claims presented to the fiduciary which have been allowed but are unpaid. There should be listed the names of the creditors, the general nature of the claims and whether any preference exists or is asserted. This schedule is informational and would be important in the case of an insolvent estate.

SCHEDULE F contains a statement of the payments and distributions of the estate's capital assets to those entitled thereto. It would be well to list in separate groups, general legacies paid in cash, general legacies paid in kind, specific legacies and legacies paid in kind out of the residuary estate. The distinction between distributions in cash and in kind is desirable in order to permit the preparation of separate cash and property reconciliation statements. The separate listing of specific legacies will facilitate the exclusion of their total in the computation of commissions. The following forms are suggested:

General legacies paid in cash:

Date of Payment	Legatee and paragraph of will containing legacy	Amount

General legacies paid in kind:

Date of Payment	Legatee, description of property and paragraph of will containing legacy	Value

Specific legacies:

Date of Delivery	Legatee, description of property and paragraph of will containing legacy	Value

Residuary legacies paid in kind:

Date of Delivery	Legatee, description of property and paragraph of will containing legacy	Value

Schedule G lists all new investments of cash, exchanges of assets included in Schedule A and further exchanges or reinvestments. This schedule is informational and does not affect accountability. The essential information may be presented in columnar form, and includes the date, cost and description of each new investment of cash and, in the case of exchanges, the names and description of the securities involved.

Schedule H contains an inventory of the capital funds and property on hand as of the last date included in the account of proceedings and is equal to the amount of the final accountability as to principal. To facilitate the preparation of separate property and cash reconciliations, the inventory should be divided into cash, property contained in the original inventory and property subsequently acquired by the fiduciary, with sub-totals for each. Forms like those suggested under Schedule A may be used.

Income Account

Schedule A-2 contains a list of the amount and date of all interest, dividends, rents and other income received. Separate money columns may be availed of for the listing of each type of income. In the case of rents, it will determine the base used for computing the additional commission payable for collecting this type of income. In listing all the income items, the usual procedure is to present them in chronological order. From an auditor's viewpoint, however, it would be more desirable to list each capital asset and then enumerate immediately below in chronological order all the income derived therefrom. This would considerably facilitate verification of the income receipts from each investment and present readily available totals for the comparison of the productivity of each asset.

Schedule C-2 contains a list in columnar form of the dates, payees, nature and amounts of all administration. maintenance and other expenses properly chargeable to income.

Schedule F-1 contains a list in columnar form of the dates, amounts and names of those to whom all income payments have been made.

Schedule H-1 contains a statement of the amount and nature of undistributed income on hand, including uncollected receivables and property rights at the last date included in the account of proceedings.

The Summary of the fiduciary's account would reflect the following:

PRINCIPAL ACCOUNT

Charges		
Original capital of fund (Schedule A)..........	$ xx	
Increases on capital (Schedule A-1)............	xx	
Total principal charges...........		$ xxx
Credits		
Realized decreases and losses on capital (Schedule B)...................................	$ xx	
Uncollectible items (Schedule B-1)............	xx	
Administration and funeral expenses paid (Schedule C)...................................	xx	
Creditors' claims paid (Schedule E)............	xx	
Legacies or distributive shares paid (Schedule F)	xx	
Total principal credits............		$ xxx
Principal balance on hand shown by Schedule H..		$ xxx

INCOME ACCOUNT

CHARGES		
Total income received (Schedule A-2)	$ xx	
Total income charges		$ xxx
CREDITS		
Administration and maintenance expenses paid (Schedule C-2)	$ xx	
Distribution of income to beneficiaries (Schedule F-1)	xx	
Total income credits		$ xxx
Balance of undistributed income (Schedule H-1)		$ xxx

The fiduciary also submits other schedules listing interested parties, showing the allocation of estate taxes, the computation of commissions, and any other facts affecting his administration.

A voluntary accounting proceeding is commenced by the filing of a petition by the fiduciary, asking for a judicial settlement of his account, together with his account of proceedings. Notice of the proceeding, called a "citation", must be served on unpaid creditors, the surety on the fiduciary's bond, if any, and others interested in the estate. It is similar to the summons, service of which usually marks the commencement of a civil action. On the return day of the citation, the fiduciary may be examined in open court under oath by any party to the proceeding as to any matter relating to the administration of the estate or fund. Hearings are held and determinations made on any objections to the account or requests for instructions.

The Supplemental Account and the Final Decree

In the intervening period between the last date included in the account of proceedings and the date when a final decree is made, the fiduciary continues to administer the estate, receiving and applying any funds or property he deems appropriate. This means that the final inventory of principal and income contained in Schedules H and H-1 will be subject to change due to the transactions during this intervening period. To bring the account up to the date of the decree, the fiduciary must submit a supplemental accounting in the form of an affidavit which lists all such transactions and indicates their effect on each schedule previously filed; it also includes a revised summary statement of the principal and income accounts and the adjusted balances of each, available for distribution.

The decree is the final step in the accounting proceeding. It is the final order of the court granting the relief sought in the petition filed at the commencement of the accounting proceeding. It is similar to a judgment in the New York State Supreme Court. The decree embodies the revised summary of the fiduciary's account as contained in the latter's supplemental accounting. It is the court order that directs the final settlement and distribution of the estate. It also fixes the amount of the fiduciary's commission and disposes of any disputed claims. Distribution will be ordered preferably in definite amounts stated in dollars and cents and not in participating fractional shares of a lump sum or an unstated balance. Likewise, the specific names of persons designated to receive amounts will be stated in the decree, rather than incorporated by reference to groups of persons,—like "the children of X". The total sum so ordered to be paid and distributed to designated recipients, should equal the total of the balances on hand as reported in the revised summary contained in the supplemental accounting. Finally, the decree releases and discharges the fiduciary as to all matters embraced in the accounting.

Recent Decisions on the Law of Corpus and Income

By John J. Traynor, C.P.A.

Introductory

When property is trusteed, either by will or deed, the donor makes a gift to two or more successive interests. Ordinarily, the fund is intended to provide an income for life or limited term with the principal or remainder thereafter passing outright.

The problem of keeping the life and remainder interests straight is not simple. A general policy of favoring Principal over Income, although conservative for the trustee, may produce incorrect results and, moreover, may not fulfill the donor's expressed or implied wishes. As far back as 1897, Justice Cullen aptly said, "The equities of a life tenant to receive the whole income that may accrue during his tenancy are every whit as great as that of the remaindermen to have the corpus of the trust preserved unimpaired." (*Matter of Rogers,* 22 App. Div. 428, 436).

The widespread increase in the use of trusts and the consequent increase in litigation involving the rights of life tenants and remaindermen have influenced our Legislature in enacting a number of remedial measures to provide definite accounting rules for certain types of problems. A number of these are embodied in Sections 17-a to 17-e of the Personal Property Law. It is important to note the effective dates of each amendment and to observe that the provisions are not applicable if the will or trust agreement provide contrarily. To some extent, this discussion will relate to said amendments.

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Accrual of Dividends on Stocks

Since the last meeting of this Committee, the Court of Appeals, in *Matter of Goldman,* 295 N. Y. 609, has upheld the use of record date. The executors were sustained in allocating to income cash dividends on shares of stock in two corporations declared prior to testator's death but made payable to stockholders of record as of a date subsequent to death. Testator's will contained no express intention as to whether the date of declaration or the record date should control in allocating such dividends.

Following that case, the Legislature, effective March 26, 1946, added to the Personal Property Law, Section 17-e, which provides in essence that

> "Where shares of stock in a corporation of this or any other state or country constitute part of an estate, trust, or other fund, and the allocation of any dividend thereon to principal or income, or between successive interests depends on the date of accrual thereof, *** the date of accrual of any dividend on such stock shall be the date specified by the corporation declaring such dividend as that on which the stockholders of record entitled to such dividend are to be determined *** or if there be no such date specified by the corporation, the date of the declaration of the dividend ***."

The rule applies to estates, trusts and other funds, whether established by will or other instrument effective before or after March 26, 1946 and is effective as to dividends received either before or after that date, except (a) that it shall not affect the allocation of any dividend which had been approved or directed by any judgment or decree or by agreement or release of the interested parties; or (b) if any such dividend shall have been distributed or paid over

in good faith by the executor or trustee receiving the same prior to March 26, 1946 on the basis that such dividend accrued on the date of declaration, instead of the date of record, it shall be deemed to have accrued on the date of declaration.

Stock Dividends v. Stock Split-Ups

In estates and trusts created after May 17, 1926, and except as otherwise provided by the instrument, stock dividends on principal investments must be credited to Principal. (Personal Property Law, Section 17-a, *Matter of Ryan,* 294 N. Y. 85, 98). As to earlier wills and trust agreements, stock dividends may be required to be apportioned. (*Matter of Osborne,* 209 N. Y. 450; *City Bank Farmers Trust Co.* v. *Wylie,* 273 N. Y. 304).

However, some trust instruments provide that stock dividends be distributed to life beneficiaries as income, or that a trustee has discretionary power to do so. In such instances, it may become necessary to distinguish between a stock dividend and a stock split-up.

This question has been passed upon within the past year in two separate construction proceedings in *Estate of Jane B. Lissberger.* (N.Y.L.J., July 1, 1946, page 6, Opinion by Delehanty, Surr.; N.Y.L.J., April 9, 1947, page 1378, Opinion by Collins, Surr.). In this estate the will authorized the trustees to pay over to the beneficiaries all dividends, whether stock dividends or otherwise, and directed that all dividends be regarded as income.

The earlier construction involved two different transactions. In one the trustee held twenty shares of common stock of a corporation which distributed to its stockholders one additional share for each four shares held. The corporation described the distribution as a split-up. It made no transfer from Earned Surplus to Capital Stock. The transaction merely multiplied the number of shares outstanding. It was held that the additional five shares were not in fact a dividend and, accordingly, not distributable as income but were to be retained with the original twenty shares as principal.

In the other instance, the trustees received a distribution from a different corporation of 100 additional shares on 200 shares already held. In this case the corporation in its resolution termed the additional shares a stock dividend. It transferred from Paid-in Surplus to Capital Account $5 for each newly issued share. Moreover, it could have declared a cash dividend out of the Paid-in Surplus. By reason of these circumstances, the court held the additional shares to be a stock dividend and, accordingly, deliverable to the income beneficiary as income.

In the latter proceedings, distinction was made between a stock dividend and a stock split-up.

In this case, the trustees received additional shares which the payor corporation characterized as a split-up. For each share held, one additional share was issued and for each such additional share a transfer was made from Capital Surplus Account to Common Capital Stock Account. The Capital Stock Account carried all of the Common Stock at a value of $1 a share. No change was made in the Earned Surplus Account.

The court held that the additional shares did not constitute a dividend and, accordingly, were to be retained as principal. It was pointed out that the feature which distinguishes a stock dividend from a stock split-up "is the permanent retention of earnings in the business through formal transfer of earned surplus legally available for dividends to capital account.[1] It was also noted that no proof was recorded that the corporation (organized under New York law) could have paid a dividend from the so-called Capital Surplus Account.[2]

Therefore, in situations requiring a

[1] Cited, Paton, Accountant's Handbook, 3d ed., page 1016.
[2] Cited, *Randall* v. *Bailey,* 288 N.Y. 280, Stock Corporation Law, sec. 58.

distinction, the criteria would seem to be to some extent whether the corporation characterizes the distribution as a stock dividend or a stock split-up but more essentially whether the distribution is merely a multiplication of shares with no change in the book value of the capital accounts—a pure split up; or the capitalization of surplus *legally available* for dividends—a stock dividend.

Amortization of Premiums on Bonds Purchased by Trustee which Contain an Option Permitting the Obligor to Redeem Them Prior to the Respective Maturity Dates

Section 17-d of the Personal Property Law provides that as to trusts created under wills of persons dying after September 1, 1942 and trusts created by deed or other instrument after date, it is no longer necessary to amortize premiums on bonds purchased by a trustee, unless the instrument directs.

As to earlier trusts, however, amortization of premiums on bonds purchased by trustees is generally required.

In a recent accounting proceeding, in an estate where decedent died prior to September 1, 1942 (*Matter of Estate of Curtis A. Peters*, N.Y.L.J., April 23, 1947, page 1581, Collins, Surr.) objection was taken to a trustee having amortized all bond premiums on the basis of maturity dates without regard to any call privileges contained in the bonds. The court held that the trustee should have amortized the premiums on the bonds to the respective call dates, taking into account the various call prices specified in the bonds. This ruling applied to bonds which were actually redeemed prior to maturity and bonds still held by the trustee.[3]

Right of Estate of Deceased Life Beneficiary to the 3% Annual Payment in Mortgage Salvage Operation

In *Matter of Edward F. Cole* (N.Y. L.J., Dec. 10, 1946, page 1682, Griffiths, Surr.), in determining the amounts respectively allocable to principal and income by reason of a completed salvage operation, a question was presented as to the application of the 3% rule embodied in Section 17-c(2) of the Personal Property Law.[4]

Decedent's will created a trust from which his widow was to receive the income for life, after which the trust was to cease and the principal be distributed.

It was contended that the estate of the life beneficiary was entitled to the payment of 3% of the principal amount of the mortgage in any year in which the earnings equalled or exceeded 3% of the amount of the mortgage. No payments of income were made to the life beneficiary during her lifetime from the mortgage or the mortgaged property.

The court determined that Section 17-c of the Personal Property Law has no application where no income from mortgage or the salvaged property has been paid to the income beneficiary during his or her lifetime, and that the income beneficiary accordingly was not entitled to any such payment.[5]

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[3] Cited, *Matter of Stevens*, 187 N.Y. 471, 475, 476, 477 (1907).
Matter of Brewster, 163 Misc. 820 (1937).
Old Colony Trust Co. v. *Comstock*, 290 Mass. 377, 195 N.E. 389.
2 Scott on Trusts, page 1337.
36 Michigan Law Review, 514.

[4] Applies to mortgages held by estates and trusts created prior to April 13, 1940, except as to mortgage investments made by such estates and trusts after that date; as stated in Section 17-c(2)a, "Net income during the salvage operation up to three per centum per annum upon the principal amount of the mortgage shall be paid to the life tenant, * * *. The amount of all such payments shall be taken into account, however, in the apportionment of the proceeds of sale and shall be charged against the share of the life tenant."

[5] Cited, *Matter of Culver*, 57 N.Y. Supp. 2nd 598 (1944), aff'd. 268 App. Div. 972, reversed on other grounds, 294 N.Y. 321.

It was directed that the net proceeds available from the salvage be allocated under the formula outlined in *Matter of Chapal* (269 N. Y. 464) and *Matter of Otis* (276 N. Y. 101).

It should be noted that the doctrine of salvage applies only to a whole mortgage or a participation or certificate of interest therein.

Allocation between Principal and Income of Certain Securities Received by Trustees in Railroad Reorganization Proceeding —Three Decisions

1. *Matter of Estate of Robert G. Reese* (N.Y.L.J., Feb., 24, 1947, page 730, Delehanty, Surr.). Trustee held certain bonds of the Chicago & Northwestern Rwy. Co. at an inventory value of $23,495. The bonds went into default and new securities were substituted in a reorganization. The new securities were sold for about $18,000.

Between the time the new securities were received and their sale, such interest and dividends as were received were allocated to income. The proceeds of sale were all allocated to principal.

The estate of deceased life tenant asserted that some of the sales proceeds should have been credited to income. The court held that the entire sales proceeds were properly credited to principal account, deeming the issue disposed of by the decision in *Matter of Otis, supra.*

The *Otis* case involved, among other questions, the exchange by a trustee of a defaulted mortgage for bonds of the Home Owners Loan Corporation, which bonds were sold later at a loss. It was held there that the exchange was not a salvage operation as in mortgage defaults but rather a sale or exchange; that the entire proceeds of sale belonged to and that the loss was to be borne by Principal.

On subsequent application for reargument on other grounds, the court reaffirmed its original decision (N.Y. L.J. June 26, 1947, page 2511, Delehanty, Surr.).

2. *Matter of the Estate of Herbert J. Carr* (N.Y.L.J. March 25, 1947, page 1158, Delehanty, Surr.) The question presented was whether any part of certain securities received by the trustees on reorganization of the Wabash R.R. and the Chicago & Northwestern Rwy. Co. were allocable to income, and if so, when.

It was stipulated by the parties that the securties in question were received for unpaid interest on the defaulted bonds.

It was held that there must be credited to income the securities received by the trustees which were earmarked and identified as representing defaulted unpaid interest* and that the specified securities were to be credited to income as of the date they were actually received by the trustees.

The latter point was of particular importance because of testator's direction that his widow receive all of the annual net income but not less than $1,000 monthly. To pay such minimum it was necessary to invade principal in those years in which the trust earned a net income of less than $12,000.

The court held that the trustees would not be justified in recouping principal payments by apportioning income payments on an accrual basis over prior years.

It was also stipulated that upon receipt of the "interest" securities the trustees had placed them in the principal of the trust and two years later sold them at a profit.

The life tenant contended that she was entitled to receive the profit on the theory that the securities belonged to her.

The court held to the contrary for the reason that what the trustees did in effect was to transfer the securities from income to principal in return for cash made available to the income beneficiary.

3. *Estate of Edgar O. Aronstein* (N.Y.L.J., July 14, 1942, page 109, Foley, Surr.).

Trust held certain bonds of Spokane

* *Matter of Thomas*, N.Y.L.J., August 17, 1944.

International Railway and a wholly owned subsidiary and on reorganization received bonds and common stock of the reorganized company in exchange.

The court approved the trustees' proposed allocation between principal and income of the new securities for the reason that recognition was accorded the unpaid interest on the old bonds up to the effective date of the plan and that such interest was placed on a parity with the principal.

The latter decisions seem to indicate that where securities in a corporate reorganization can be related to or earmarked as unpaid interest, the same may be allocated to income account (limited, however, to the extent of unpaid interest which had accrued during the period the old securities were held by the trust) while the first decision indicates that where the reorganization effects simply an exchange of principal securities the new securities go to Principal Account.[6]

Prepaid Interest on Bonds

From time to time, offers are made to bondholders to surrender their bonds in exchange for new bonds, usually at a lower rate of interest, and in connection with some such exchanges, as an inducement, an interest bonus is paid beyond the redemption or exchange date and sometimes beyond the next interest date. The question of whether such additional interest should be credited to income or principal does not appear to be fully settled.

In *Matter of Rockefeller*, N.Y.L.J., April 7, 1944, page 1359, Foley, Surr., it was held that interest prepaid to the trustees on redemption of Triborough Bridge Authority and New York City Housing Authority Bonds constituted true income payable to the life beneficiary.[7]

The court relied upon Federal tax rulings and upon the language of the will, presumably Article 14 thereof, which reads:

> "I direct my said Trustees to apply the entire income of all securities at any time held by them to the use of the beneficiary for whom they are held, irrespective of the price paid for them or of their market value at any time; it being my intention that no part of such income should be applied as a sinking fund to offset the gradual loss of the premiums upon, or market value of any such securities."

In *Matter of Goldwater*, 175 Misc. 814 (1940) Delehanty, Surr., where bonds were called for redemption at 105 and interest extending for a number of future periods, the court held that the interest from the last coupon date to the date of redemption belonged to income and that the premium paid for the privilege of redemption (inferentially the interest in respect of the period beyond the redemption date) belonged to capital.[8]

Until the point is fully settled, it is suggested that the question be resolved in accordance with the circumstances of each case, e.g., terms of the will or trust instrument, market value of or proceeds of bonds at redemption date in relation to cost and such other factors as might be pertinent.

Depreciation of Real Estate in Trust and Amortization of Mortgage

Re: *Danziger's Will*, 58 N.Y.S. 2nd 794 (1945), Modified 67 N.Y.S. 2nd 130 (1946).

Testator, at the time of his death, and another were each the owners of one-half the stock of an 81-family apartment house. The corporation was indebted to both for a loan of about

[6] See also *Matter of Shaffer*, 178 App. Div. 117, 165 N.Y.S. 19, aff'd, 222 N.Y. 533.

[7] Cited, *Matter of Outerbridge*, N.Y.L.J., Dec. 15, 1943, page 1773, Foley, Surr.
Old Colony R.R. v. *Commissioner*, 284 U.S. 552;
U. S. Treasury Dept. Ruling G.C.M. 21,890, C.B. 1940-1, page 85.
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[8] Cited, *Whittemore* v. *Beekman*, 2 Dem. 275, 285.
Scovel v. *Roosevelt*, 5 Redf. 121, 124, 128.

$50,000. About three years after testator's death, the corporation conveyed the property to the surviving stockholder and the trustee of a trust under testator's will, thereby extinguishing the debt.

In his account, the trustee reported in the income schedule the sum of $8,850 as "profits withdrawn from the partnership owning 69-01 62nd St., Ridgewood." The facts established that the profits realized on operation of the property on a cash basis were about $28,000.

The trustee contended that in computing the actual profit, a reserve of some $9,400 for depreciation and the sum of $10,000 paid in reduction of the principal of the first mortgage should be taken into account.

Testator's will provided:

> "I further instruct my executors and trustees to retain my interest in the apartment houses located in Ridgewood, Borough of Queens, City of New York, and to invest such additional monies in said holdings as may be required from time to time."

It was held that the amortization payments were properly chargeable to principal and did not constitute charges against income and that "even if there was a direction in the will, which there is not, for a payment of income for amortization charges or payment of the entire mortgage such direction would be void as an accumulation of income.[9]

As to depreciation, it was held that the rents which constitute income cannot be charged with a reserve to meet depreciation of the real estate."[10]

Conclusion

It is urged again that in each estate or trust dealt with, the will or trust instrument be studied carefully and that all points of law concerning which the accountant is in doubt be submitted to counsel for advice.

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9 Cited, *Thorn* v. *DeBretcuil,* 86 App. Div. 405, 83 N.Y.S. 849, aff'd. 179 N.Y. 64, 71 N.E. 470.
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Real Property Law, §63.
Personal Property Law, §11.

10 Cited, *Matter of Schummers' Estate,* 210 App. Div. 296, 301, 206 N.Y.S. 113, 117, aff'd. 243 N.Y. 548, 154 N.E. 600.
Smith v. *Keteltas,* 62 App. Div. 174, 70 N.Y.S. 1065.
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Scott on Trusts, Vol. 2, §239.4.

SUMMARY OF AMENDMENTS TO SECTION 17 OF THE PERSONAL PROPERTY LAW OF NEW YORK

(Provisions noted are inapplicable where terms of will or trust instrument provide to the contrary)

Section	Effective	Subject
17-a	As to trusts created by wills, deeds, or other instruments executed after May 17, 1926.	**Stock Dividends** Stock dividends received by trusts on Principal investments form part of Principal.
17-b	As to estates of persons dying after April 24, 1931.	**Estate Income** Distribution of Income earned during period of estate administration not otherwise disposed of by will is distributable pro rata among beneficiaries of residuary trusts and the other persons entitled to the residuary estate. None of such Income shall be added to the capital of the residuary estate, the whole or any part of which is devised or bequeathed in trust. Unless otherwise directed in the will, Income shall be payable to the life beneficiaries of trusts from the date of testator's death.
17-c	(1) As to estates of persons dying on or after April 13, 1940 and to trusts created under a deed of trust or other instrument executed after that date and to investments of mortgages thereafter made by a trustee of an *existing trust*, whether testamentary or *inter vivos*.	**Salvage Operations** Real property acquired by foreclosure or conveyance in lieu thereof shall become a Principal asset in lieu of the mortgage. The life tenant is entitled to the net income from such acquired real property and no apportionment of the proceeds of sale shall be made.
	(2) As to (a) estates of persons dying before April 13, 1940 and (b) to mortgages on real property held by a trustee under an instrument executed before that date and (c) to real property acquired by foreclosure before or after April 13, 1940 in trusts created or mortgage investments made prior thereto.	The existing rules of procedure applying to salvage operations as laid down in *Matter of Chapal, supra,* and *Matter of Otis, supra,* are continued, except as modified, and notably that Income earned during the salvage operation up to 3% per annum of the amount of the mortgage shall be paid to the life tenant; the amount of such payments shall be taken into account in the apportionment of the proceeds of sale and shall be charged against the share of the life tenant.

Section	Effective	Subject
17-d	As to testamentary trusts created by wills of persons dying after September 1, 1942 and *inter vivos* trusts created after that date.	**Amortization of Bond Premiums** Bonds or other obligations for the payment of money forming any part of the Principal shall be deemed Principal at the inventory value, or if there be none at the market value at the time the Principal was established, or at their cost where purchased later, regardless of their par or maturity value; and upon their respective maturities or upon their sale, any loss or gain realized thereon shall fall upon or inure to the Principal.
		Discount Bonds When any part of the Principal consists of a bond or other obligation for payment of money, bearing no stated interest but redeemable at maturity or a future time at an amount in excess of the amount in consideration for which issued, the amount of such accretion earned during the period such bond or other obligation was held by the trustee, shall inure to Income.
17-e	As to estates, trusts and other funds established by will or other instrument effective before or after March 26, 1946.	**Date for Accrual of Dividends** The date for accrual of dividends on shares of stock forming part of an estate, trust or other fund shall be the date specified by the corporation declaring such dividend as the "date of record."

A Review of Recent Decisions in Accounting for Common Trust Funds

By Orrin R. Judd, C.P.A.

The common trust fund is a plan of investment by corporate trustees under which the moneys of many small trusts, that cannot advantageously be invested separately, may be combined in a common fund, each trust being assigned a proportionate share therein. Its use by trust companies and banks having trust departments has been authorized by law in a number of states, and the Federal Reserve Board on December 31, 1937, made effective a regulation permitting National Banks to establish common trust funds. In New York Section 100-c of the Banking Law, adopted in 1937 and amended in 1943, authorized any trust company upon receiving permission of the Banking Board to establish one or more common trust funds, to be known either as a legal common trust fund or a discretionary common trust fund, for the investment needs, respectively, of trusts requiring legal investments, and trusts that do *not* limit investments to "legals" but leave them to the discretion of the trustee. Not more than $50,000 of any one estate or trust may be invested in a common trust fund. The law prescribes a type of notice of investment to be sent by the trustee to persons entitled to share in the income or principal of the particular trust.

Orrin R. Judd, C.P.A., has been a member of the Society since 1903 and has served for several years on the technical Committee on Fiduciary Accounting. He was graduated from the School of Commerce, Accounts and Finance of New York University, with the degree of B.C.S., in its first class, in 1902, and from the School of Law, with the degree of LL.B. in 1904. He was also admitted to the New York Bar in 1904. For six years he lectured on Banking Practice in the School of Commerce.

His public practice has been mainly in the field of banking, institutional and fiduciary accounting. He served in the Trust Departments of the Knickerbocker, Columbia and Irving Trust Companies, retiring as a Vice-President of the latter in 1933. Since 1935 he has been connected with The Kings County Savings Bank of Brooklyn, of which he is now Vice-President.

He is Secretary of the Council of New York University. He is a member of the Advisory Board of the School of Accountancy and Business Administration of Pace Institute.

The law provides that not less than twelve nor more than fifteen months after the date on which a common trust fund is established and triennially thereafter, the trust company shall file an account of its proceedings in respect thereof "either in the office of the clerk of the Supreme Court in the county in which such trust company maintains its principal office or in the office of the surrogate of such county," with a petition for its judicial settlement setting forth a list of all the participating estates, trusts or funds. Notice of the filing shall be published not less than once a week for four successive weeks in a newspaper to be designated by the court, addressed generally, without naming them, to all parties interested in the fund and in the estates, trusts or funds mentioned in the petition, without setting forth the residence of any decedent or donor of any such estate, trust or fund, requiring all such parties to show cause on a day to be fixed by the court why such account should not be judicially settled. Upon the filing of the petition the court shall appoint two

competent and responsible persons, one to appear as special guardian and attorney for each infant and incompetent not appearing by general guardian or committee, and for each other party known or unknown who does not otherwise appear in the proceeding, who has or who may thereafter have any interest in the income of the fund, and the other of such competent and responsible persons to appear similarly for parties who may have any interest in the principal of the fund.

Five trust companies in the state of New York have established common trust funds, the Marine Midland in New York City, June 13, 1944, the Bank of New York, January 31, 1945, the Continental Bank and Trust Company of New York, March 1, 1945, the Central Hanover Bank and Trust Company of New York, January 31, 1946, and the Security Trust Company of Rochester, June 21, 1945.

The Marine Midland Trust Company filed its first account as of July 31, 1945, in the Surrogate's Court of New York County, and it was approved and judicially settled by a decree of Surrogate Delehanty entered April 2, 1946.

The Bank of New York filed its first account in the Surrogate's Court of New York County, with a petition asking for its settlement and asking for instructions in respect of many matters affecting the operation of the fund, and Surrogate Delehanty, in an opinion printed in the New York Law Journal of December 5, 1946 (67 N.Y.S. (2nd) 444) ruled on the questions asked and, also, on some points raised by the special guardians. This decision may well be taken as establishing a standard procedure for the operation of common trust funds in New York. It is too long to be quoted in full but this review would be incomplete if it did not cover the main points of the decision. The Surrogate discusses generally the nature and legal background of the common trust fund and then deals with the questions presented in this accounting. He says:

"Allocation of Charges

"The first question has to do with the charging of the expenses of the accounting and the time of such a charge. In this connection it is necessary to refer to subdivision 4 of section 100-c of Banking Law and to Article X (8) of the Regulations of the Banking Board. These say that no commissions or compensations can be taken by the corporate fiduciary for management. The Regulation says that nothing in the prohibition against management shall prohibit the payment of reasonable expenses. The first question is whether or not the expenses of an accounting are a 'charge against such fund for the management thereof' within the terms of the statute and the regulations. The court holds that the ordinary expenditure for the court accounting which is prescribed by statute may be paid out of the common fund and is not a 'management' charge. . . . The special guardian appointed for principal account argues that the income account of the common trust fund should bear some part at least of the expenses of the accounting. The special guardian for income contends that the charge must be borne wholly by principal. . . . The court is of the view that the charges must be borne wholly by principal account. The cost to principal is not great. If loaded even in part on income the burden would be disproportionate. But in any event the concept of the fund as an entity requires that the charge be made to principal and so the court rules."

"Time and Manner of Charging Costs

"The next question concerns the time of making the charge. . . . It would be impracticable to attempt to allocate the charges to the individual participations and the periods of time during which each investor had a participation. . . . The simple and effective procedure is to make the charge operative at the date of the decree without any reserve and without any contributions from the participations theretofore withdrawn from the fund."

"Amortization of Bond Premiums

"The next question has to do with the amortization of premiums paid on securities purchased by the operator of the common trust fund. . . . Having determined that no amortization is required in the case of a common trust fund the request for instructions as to the method of amortization requires no answer."

"Treatment of Stock Dividends

"The next point which requires discussion has to do with stock dividends. . . . The participant has only his interest in the fund and its income as established by the statute, the Banking Board Regulations

and the plan of operation of the fund. The placing of stock dividends in the capital of the fund is entirely valid. . . ."

"Treatment of U. S. Bonds, Series G

"Another problem is presented by the petition which asks whether participations in the fund may be paid for by the participant by exchange of United States bonds, Series G, at par. . . . The effect of a validation of the practice is to bring in to the discretionary fund a volume of sound securities on which no loss can ever be sustained if the securities are held to maturity. The procedure followed by petitioner is sound and is approved by the court. . . ."

"Permissibility of Participation

"When individual accountings in individual estates or funds are had it will be appropriate to construe the underlying instruments. Here the court should and does limit itself to ascertainment whether the trustee of the common fund has properly accounted for all of the assets received by it and has properly managed the fund so as to secure to participants their rights in principal and income thereof."

The Continental Bank and Trust Company of New York filed its first account in the Surrogate's Court of New York County and it was approved and settled by decree of Surrogate Collins, printed in the New York Law Journal of December 9, 1946, (67 N.Y.S. (2nd) 206).

The Central Hanover Bank and Trust Company of New York, whose common trust fund was established January 31, 1946, recently filed its first account in the Surrogate's Court of New York County, and the account is at present under consideration by the Court.

The Security Trust Company of Rochester filed its first account under Plan dated June 21, 1945, with petition for judicial settlement, in the Surrogate's Court of Monroe County in September, 1946. The special guardians objected to the court's jurisdiction on the grounds that the Trust Company has commingled in the fund moneys from *inter vivos* trusts and moneys from testamentary trusts, and that the notice of application for judicial settlement was insufficient to meet the requirements of "due process of law" under both the federal and state constitutions. On April 30, 1947, Surrogate G. Robert Witmer of Monroe County dismissed the petition for lack of jurisdiction, stating that in his opinion the legislation enacted in connection with common trust funds was not sufficient to give the surrogate's court jurisdiction over *inter vivos* trusts. On the question of the primary notice of investment in the common trust fund, which is intended to estop beneficiaries from objecting to such investment of their trusts, and the notice by publication of application for judicial settlement of the common trust fund, the Surrogate held that even though they were in strict compliance with the statute they were insufficient "to provide the kind of notice which the conscience of the people of the State of New York as expressed by the Constitution, the Legislature and the Courts, has heretofore always required."

No doubt an appeal from Surrogate Witmer's decision will be taken to the Appellate Division of the Supreme Court for the Fourth Department, and thereafter to the Court of Appeals, which is the highest judicial authority in the State of New York. However, there is a possibility that the same questions may reach the court earlier through an appeal that has already been taken to the Appellate Division of the First Department from a decision of Surrogate Delehanty of New York County in the matter of the *Estate of Ella J. Hoagland,* reported in the New York Law Journal of May 27, 1947. In that case objection was made to an investment by the Bank of New York in its Discretionary Common Trust Fund, on the ground that a participation in a discretionary common trust fund is not a security within the meaning of the will, which authorized the trustee "to invest in such other securities besides those recognized by law as proper for trustees as my said trustee may deem wise and desirable." The court held that such a participation is

in fact a security as that term is now understood, saying:

> "Shares in investment trusts are currently bought and sold and are regarded in the market-place as securities. A common trust fund is an investment trust in effect."

A separate objection relating to the amortization of premiums paid for securities purchased by the common trust fund was overruled. The Court regarded this objection as raising issue respecting the court's jurisdiction over such a fund and respecting the effect of a decree settling an account for such a fund, and in conclusion said:

> "When it exercised jurisdiction under subdivision 10 of Section 100-c of the Banking Law over an account by the trustee of a common trust fund this Court necessarily held that it was not going outside the jurisdiction conferred on it by the legislature under constitutional authority. This viewpoint will be adhered to despite the high respect which this Court entertains for the writer of the opinion in *Matter of Security Trust Company of Rochester*, decided in Monroe County on April 30, 1947."

To the lay mind it seems that common trust funds are in the public interest, because they make possible the satisfactory investment of trusts that are too small for banks to administer separately and they afford diversification, liquidity and economy of operation impossible to obtain in separate investment.

In any event it ought to be possible to overcome any legal objections to efficient accounting procedure for common trust funds either by judicial construction or amendment of existing laws. The common trust fund was created to provide an economical form of investment for small trusts. The Monroe County decision, which attempts to entangle it amid all the elaborate accounting procedure of a separate trust defeats the purpose of the legislation. Notice that the investment has been made should charge the beneficiary with knowledge that the law prescribes a simplified form of accounting. Indeed, the opportunity to file objections on a triennial accounting gives a beneficiary much greater rights than he would have against the directors of an investment trust in whose shares a trustee vested with discretionary powers might properly invest trust funds. As to the objection to the Surrogate's jurisdiction, it seems captious to dispute his power when the Legislature has specifically authorized investing the funds of estates and trusts alike and has expressly authorized accounting in a Surrogate's Court.

A Bibliography on Estate Accounting

By Arthur B. Moll, C.P.A.

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Arthur B. Moll, C.P.A., is Chairman of the Society's Committee on Fiduciary Accounting, Vice-chairman of the Committee on Admissions and a member of the Committee on Monthly Audits. He has been a member of the Society since 1928, and has been a previous contributor to this publication.

Mr. Moll is also a member of The New York Credit Men's Association's Committee on Cooperation with C.P.A's. He is a partner of H. E. Van Benschoten & Co.

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- Books (or parts of books) and Pamphlets
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Compensation Arrangements Today

By Glenn O. Williams, C.P.A.

One of the major problems of corporations today is to attract and hold men of outstanding managerial ability, and to provide them with incentive to greater effort and assumption of larger reponsibilities. Financial reward alone is not the complete incentive. Love of work, pride in accomplishment, and the associations with others are also important incentives to individual progress. However, while not the sole factor involved, in most cases financial reward must be, of necessity, the greatest single attraction and incentive. Higher position creates heavier financial burdens for the incumbent.

The difficulty of solving this problem has been seriously magnified in recent years by the progressively mounting rate of income tax on increases in compensation. In order to reward an employee fairly and adequately for the assumption of increased responsibility, his nominal or gross compensation must be increased by a greater amount than was previously considered appropriate, to enable him to defray an important part of his greatly increased taxes as well as his other enlarged expenses. Without such treatment the incentive to advancement to a more important position is materially lacking.

Now, for example, we shall consider the effect of the 1946 Federal Personal Income Tax on an employee receiving $10,000 gross compensation (assuming he is a married man with two children, taking the optional standard deduction of $500.) If the employee receives the $10,000 gross compensation he will retain $8,300 after personal income taxes, whereas the employee receiving $50,000 gross compensation, five times as much, will retain about $26,200, or only three times as much. In order to increase by $10,000 the net compensation of an employee who is now receiving $26,200, to compensate him adequately for the increased responsibility resulting from an important promotion, it would be necessary to increase his nominal, or gross, compensation from $50,000 to $90,000 per year—an increase of $40,000, or four times the additional net compensation derived by him. However, this raises the question—

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Mr. Williams has served on several committees of the Society and as President of the Rochester Chapter. He is at present Vice-Chairman of the Council on Accountancy of the University of the State of New York.

What Is Reasonable Compensation

Reasonable compensation is another major problem of corporations today. As you know, it cannot include deductions for payments to employees motivated merely by a desire to be helpful—that is, to aid a sick employee; to reduce an employee's indebtedness; to make up his loss; or to distribute large corporate earnings. If they were to be allowed at all, such payments would have to be justified as ordinary and necessary business expense, customary in the trade or in the locality of the business.

The proof of reasonableness of salaries is always a burden upon the Company which pays them. In the past, the Treasury has been harsh in its reviews;

indeed, recent cases have indicated that the Courts are more inclined than the Treasury to take a liberal view as to what constitutes allowable compensation. In this connection see the table of salaries allowed by The Tax Court at the end of this article. While different facts govern in each case and various types of businesses are involved, a study of the table may be rewarding to discover what percentages of sales were involved as salaries, what dividend policies, if any, were pursued, and so on.

In analyzing the cases for principles involved, it would appear that some of these might be stated as follows:

1. If the compensation was paid by a family or closed corporation, the amount of salary allowed would be dependent on the following factors:
   a) The income, growth and volume of the business; the duties and abilities of the individuals.
   b) the services actually rendered by the individuals.
   c) The Company's success was bound up closely with the abilities of the individual.
   d) If salaries bore any relation to stockholdings, they may be suspect as disguised dividend payments.
2. In the instances where salaries do bear a relation to stockholdings, it might be deduced that:
   a) The salaries would be approved if the amounts were related as well to the responsibility and character of the services performed.
   b) Understandings as to bonus arrangements have existed for years to give bonuses when profits were earned. This would be particularly true of growth corporations where it has been desirable to plow back profits for expansion of the business.
3. Even though compensation arrangements were made at or near the close of the fiscal year, the amounts would be allowed if they represent reasonable payments for services actually rendered.
4. In the cases where no dividends were paid and the salaries themselves were high, the tests to be applied would be:
   a) Does a substantial surplus remain after payment of the salaries?
   b) Is there any relationship between stockholdings and salaries? In this instance, the disguised dividend test again would apply. In the absence of such a "disguise," the salary presumably would be allowed to stand.
5. The test of salaries and salary ranges within an industry is always an important one. If competitors are paying similar salaries, this in itself would seem to be *de facto* evidence that the salaries were reasonable.

Recent Rulings and Observations

In the case of the *Eagle Office Equipment Co.*, 5 T.C.M. 967 (1946), the taxpayer was in the business of selling stationery, office equipment and supplies. The corporation had established a policy of paying its president a salary plus a commission. In the year under question, the Tax Court allowed the president a salary of $7,000 plus commissions of $38,000. This total remuneration of $45,000 amounted to several times what the president had earned before and the Commissioner argued that the large increase in income was made possible only by the wartime sellers' market.

The Tax Court, in deciding against the Commissioner, expressed the view that the merchandise, despite easier selling conditions, still had to be sold, that the large sales of the president were due to his personal efforts and good connections with manufacturers—the contacts with manufacturers, of course, being particularly valuable during the war years. From one view it would seem the president reaped the benefits of prior years efforts during which time he presumably devoted much effort to building up connections which served him well in later years. Possibly this is what the Court had in mind when it allowed the liberal compensation.

Another situation that many of us have run into recently is in connection with retroactive bonuses and wage increases to compensate for lower salaries under the wartime salary stabilization acts. Retroactive bonuses can often be substantiated if buttressed by some of the arguments stated above, but some agents seem to have taken the position that wartime wage ceilings not only

placed a statutory maximum on salaries but also established the reasonableness of those salaries as well. Therefore, if a salary's reasonableness was established, any retroactive adjustment is perforce unreasonable and the salary should not be allowed as a deduction.

We still do not know what will be the outcome of the Treasury Agents' attitude; it would be my opinion that their argument stands on very weak ground. It would seem good judgment to contest any such decisions either until a more definitive policy is laid down from the top or until litigation settles the argument one way or the other.

Some of the results of the litigation concerning wartime profits and salaries are just beginning to filter through to us. Admittedly these were disproportionate, particularly when viewed with the 1930s as a standard, and it is more or less to be expected that the Commissioner will attempt to upset bonus payments, even though based on longstanding contracts, where he thinks the bonus paid to be excessive. The case of the *Locke Machine Co.* (T.C. #8582) is a good one in point.

The Locke Machine Company had a profit sharing plan that went back to 1927. Its method was first to set aside a percentage of profits either to pay dividends or to increment surplus and then to pay out as bonuses to four executives thirty per cent of the amount remaining after this segregation. In 1941, due to the influx of war business, the Company earned three times as much as it had in 1939. The bonuses paid to officers likewise increased proportionately although their duties were only nominally greater. Despite this longstanding percentage bonus contract, the Tax Court ruled that the compensation paid must still meet the test of reasonable salaries, and in so ruling, seemed to create a new concept of tax law. The Court stated in part: "The condition of this taxpayer was very similar to that of practically all concerns engaged in similar businesses in the United States and if this taxpayer can deduct inflated salaries which are based upon abnormal war profits because such compensation resulted from a long established policy of the taxpayer corporation, then the requirement that all salaries must be ordinary, necessary and reasonable has not been observed, and the Government, at a time when it needs tax income most vitally, will be unjustly deprived of such income."

In the past, court decisions, however must we might have disagreed with them, seemed to have been based on hard-headed business reasons. In the case of the Locke Machine Co., the Court seems to be swinging off onto a semi-socialistic tangent which looks to the greater good of the greater number rather than to be adhering to the good old capitalistic philosophy of "Every man for himself, and the devil take the hindmost." Similar arguments that "the government needs the money" can be induced in many instances, but they would seem inconsistent with a literal interpretation of the law.

Here is another recent case which, while not concerned with the establishment of reasonable salaries, does illustrate the fact that once a salary has been paid, it cannot be repaid with benefits taxwise in later years. In 1941, a corporation paid its three officer-stockholders salaries which in 1943 were disallowed in part. The corporation, upon paying the additional tax necessitated by the disallowance, discovered it was left with a deficit. In order to correct this condition, the officers paid back enough of their "excessive" salaries to turn the deficit into a surplus. Having thus taken care of the corporation's financial affairs, they then attempted to set their own in order by filing refund claims for their personal income taxes paid on the excessive salaries in 1941. The Circuit Court ruled against any recovery of taxes, holding that salary paid in one year and repaid in a later year is taxable to the employee even though the salary was excessive and the corporation was not allowed a deduction for a portion of it.

What our men should have done, of course, had they been gifted with foresight rather than hindsight, was to have repaid the salary in 1941, the same year in which the excessive amount would have been paid. Had they done so, they would have avoided the double tax on both their disallowed salaries and on the corporation's income.

Importance of Payment of Salary Accruals

We are all familiar with the tax avoidance stratagem of former years whereby a corporation on the accrual basis could deduct accrued salaries due its majority stockholder-employee; the employee, being on the cash basis and of generous nature, would never press the corporation for payment, and hence he would not have to pay any tax on the salary deducted by the corporation. The Section 24 (c) closing of this loophole has laid down the rule that the deduction is forfeited if the accrual is not paid to the cash basis taxpayer within two and a half months after the end of the corporation's fiscal year. Out of this ruling, too, has grown a series of litigations and rulings as to what constitutes payment and constructive receipt.

The two-and-a-half month rule encompasses not only salary payments but applies to all types of expenses and all types of taxpayers. Furthermore, the obligation must be owed by the accrual basis taxpayer to a "related taxpayer." When we speak, then, of "related" taxpayers, we get into a whole new series of definitions, to say that "related" taxpayers include the following:

1. An individual and a corporation in which he owns, directly or indirectly, more than 50% of the stock.
2. Members of the same family.
3. Two corporations, one of which is a personal holding company, in which more than 50% of the outstanding stock is owned by the same individual.
4. Certain grantors and fiduciaries, and fiduciaries and beneficiaries.

In passing, I might note that there have been cases where the deduction was allowed even though the accrual was not paid on time. In view of what I have just said regarding constructive receipt, it is probably better to hew to the exact letter of the law rather than to rely on the cases that are the exceptions and then perhaps be forced into expense litigation. Probably the soundest procedure would be to borrow money to make the payment if the cash were not available to pay the accrual. If it were possible to borrow the money, an alternative procedure is to give a note in payment. Would this pass the test of Section 24 (c)? It is my opinion that it would—if the note were given before the end of the corporation's fiscal year. On the other hand, a note given at a time falling *between* the close of the fiscal year and the time of filing would not seem to constitute "constructive receipt" and the corporation would not be entitled to a deduction for what in this instance is the accrued salary of an officer-stockholder.

Deferred Compensation

Where a corporation desires to reward a worthy employee upon his retirement or withdrawal from the business and at the same time give him the maximum amount of "take home" pay, a plan of deferred compensation very often can be worked out. Such a plan would have real advantages to the employee although conversely the corporation would lose the benefit of a present day deduction or else be forced to make the payment either when tax rates were lower or even when profits were non-existent.

To illustrate how this plan might be worked to an employee's advantage, consider the case of the executive with no dependents drawing a salary of $20,000 a year. His company wishes to give him a bonus of another $20,000 upon his retirement. Let us assume further that other income offsets exemptions and deductions. If this bonus

were given to him immediately (assuming no change in today's tax rates), he would pay an income tax of $18,753 on his total income of $40,000, leaving him net compensation of $21,247.

Now, suppose his company foresightedly agrees to give him his usual $20,000 salary, plus five payments of $4,000 each over the next five years. His income tax on the $20,000 amounts to $6,897, while his tax on the five $4,000 payments will amount to $798 per year for five years, a total of $3,990, or total taxes paid over the period of $10,887. This constitutes a net saving of $7,866 to the employee.

In our tax thinking, we are again confronted with the problem of whether this will constitute "constructive receipt" of income. In this case I believe we can state with a reasonable degree of certainty that an employer's promise to pay in the future will not be treated as income constructively received even though a financially stable corporation is making the promise. Furthermore, the Treasury also seems inclined to take a liberal view of the "reasonableness" of bonuses paid for services rendered in prior years, and would not be inclined to disallow such bonuses as tax deductions, when viewed in the light of services rendered over the entire employment period.

Stock Options

As a means of giving valued executives additional compensation and also of tying their services securely into their company, the device of stock options has been used by corporations. It has been hoped that the executives favored with stock options would pay taxes at ordinary rates only between the option price and the fair market value at the time the *option was given.* Any further increase in value until such a time as the *option was exercised* presumably would be capital gain and taxed at a maximum 25 per cent rate.

The Supreme Court, in the case of *Commissioner* vs. *John H. Smith,*[1] has upset this reasoning by holding that the difference between the option price and the fair market value of the stock at the time the option was exercised, is ordinary income and taxable as such. The Court construed that the option was granted as additional compensation and hence there should be no differentiation between compensation received in cash and that received in corporate stock. Without presuming to question the Court's decision, it is, nevertheless, apparent that few employees would be able to pay income taxes at rates running up to 86.45 per cent without selling some of the stock which had been given them as additional compensation.

Indeed, as we go to press, the newspapers are carrying the story that Darryl F. Zanuck, vice-president of Twentieth Century-Fox Film Corporation, is planning to sell on the open market 100,000 shares of this company's stock which he acquired under an option. Mr. Zanuck acquired his option in 1940 when the stock was selling for $10.625 per share. The option gave him the right to buy the shares at $13.00 per share; he exercised this option on July 15, 1946, when the market price was $51.50 per share. He is selling today at a time when the quoted market price is $27.75 per share. What will the Treasury's attitude be on this transaction? It is possible they will endeavor to hold that the 100,000 shares were compensation and that Mr. Zanuck should pay income tax on the difference between the option price of $13.00 and the value of $51.50 at time of exercise of the option—a tax on $3,850,000 of income. If this were held to be compensatory income, then Zanuck presumably would today have a capital loss on the difference between the $51.50 and the market price of the stock at time of offering. If this $3,850,000 were ordinary income, it is no wonder Zanuck has to sell his stock to pay taxes!

What, then, is the solution to this

(1) 324 US 177, 695 (1945).

Scylla-Charybdis dilemma of the Court's adamant determination to tax stock options at ordinary rates? One possibility, at least, would be the adoption of the Surrey plan to place all taxpayers on a tax footing equal to that enjoyed by residents of the community property states. This would afford some relief at least to executive-benedicts, but would leave bachelors in the same tax predicament as now. Yet what bachelor deserves sympathy? All the unmarried ladies in the country would doubtless echo the same thought. "It serves them right."

SALARIES ALLOWED BY THE TAX COURT

Type of Business	Tax year	Sales (000 omitted)	Net Profits After Officers' Salaries (000 omitted)	Dividends Paid (000 omitted)	No. of Officers	Salaries: Deducted for these officers	Salaries: Allowed for these officers
Manufacturer of electrical heating equipment	1941	222	41		1	$ 56,000	$ 40,000
Industrial engineering	1941	87	11		1	19,000	19,000
Automobile sales and repairs	1942	248	6		2	23,000	18,000
	1941	653	12		2	29,000	18,000
	1940	553	7		2	21,000	15,000
Manufacturer of soft drinks	1943	133	1		2	24,000	16,000
	1942	117	7		2	18,000	16,000
Lumber and steel dealer	1941	2,000		(6% on all stock)	1	45,000	45,000
Manufacturer of machines and tags	1941	669	295	("Substantial" amounts)	2	72,000	72,000
Engineering construction	1940	2,700	312	50	2	200,000	120,000
	1938	1,700	223		2	200,000	120,000
Coal mining	1941	3,000	31		3	64,000	25,000
Building construction	1941	2,900	28		1	50,000	25,000
	1940	1,600	48		1	50,000	25,000
Marine construction and dredging	1941	18,900	466		2	126,000	96,000
	1940	4,900	228		2	73,000	59,000
Manufacturer of steel castings	1942	1,900	289	22	4	124,000	99,000
	1941	1,300	177	20	4	117,000	91,000
	1940	700	61	9	4	63,000	63,000
Cotton goods converter	1941	5,800	196		4	94,000	71,000
Manufacturer of tin cans	1941	179	28		4	27,000	22,000
Broker and shipping agent	1941	3,000		60	2	141,000	120,000
Processor of meat sausages	1940	252		4	3	45,000	33,000

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Corporations Subject to Article 9A Tax

The franchise tax is a tax on the privilege of exercising a corporate franchise. Therefore as soon as articles of incorporation have been filed, the state has granted a charter to this newly created entity to be a corporation, and the corporation is subject immediately to a franchise tax. It remains subject to this tax as long as it remains in existence, even though it does not engage in any activity. A domestic corporation would thus be subject to some franchise tax even though all of its business were carried on entirely outside New York. This is the substance of Article 130 of Regulations 9A which is based upon Section 209.1 of the law.

This liability for the franchise tax continues at least until the corporation has been dissolved. The actual date of dissolution is the date on which the certificate of dissolution has been filed. After that date a corporation may be engaged in activities concerned with liquidation, that is disposing of its assets, paying liabilities and distributing the net assets to the stockholders, without being subject to tax. Liquidating activities do not constitute doing business. However, if the corporation after filing its certificate of dissolution does engage in business for profit it is still subject to a franchise tax.

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The foreign corporation is in a somewhat different category. It becomes subject to the franchise tax only if it actually does business in New York. While the law requires a foreign corporation to qualify in New York if it means to carry on business here, it is nevertheless subject to the tax even though it does not qualify formally. As a matter of fact, most cases before the State Tax Commission involving foreign corporations are concerned with corporations that have not qualified in New York, but whose activities are deemed by the Tax Commission to constitute such doing of business as to be subject to tax.

Now a foreign corporation may carry on interstate activities and not be taxable on what it does in New York. In addition, certain activities are specifically exempt and may be carried on in New York without being subject to tax. For example, the foreign corporation may maintain bank accounts in New York. It may keep securities in a safe deposit box in New York or with a broker for safekeeping, provided the broker is a member of a recognized security exchange. It may own merchandise which is held in New York by an independent factor on consignment for sale. It may even maintain a sales office of salesmen in New York for the solicitation of orders, provided the orders are accepted outside the state and the merchandise is shipped from a factory outside the state.

A foreign corporation is required each year to file form 245 C.T. which describes the nature of its activities in New York. This enables the Tax

Commission to determine whether the activities constitute doing taxable business in New York. It has not been the practice of the Commission to notify the foreign corporation that on the basis of form 245 C.T. it is not subject to tax. If that is its determination, it merely takes no further action. Is it then necessary to file form 245 C.T. each year? The law itself does require an annual filing, but as a practical matter, it is not necessary to file this form each year, unless the activities of the foreign corporation have changed in any way.

Doing Business in New York

The regulations (Article 141) enumerate eight factors that will guide the Tax Commission in determining whether a foreign corporation is doing taxable business in New York. The mere ownership of real property in New York constitutes doing business. The nature and extent of the activities in New York compared with its activities elsewhere is another factor. This factor is aimed at those more or less quiescent corporations organized outside the state with a statutory office say in Delaware and the little activities required being carried on in New York. The holding company is vulnerable by this yardstick. The location of its offices and other places of business is a factor, but a statutory office is not an office or permanent place of business outside the State. The employment in New York of agents, officers and employees is another criterion. But it should be noted that if such agents and employees are part of a sales office, the corporation may be doing only an interstate business and on that ground alone it will not be taxed in New York.

Whenever a definition of doing business is attempted, reference is made to continuity, frequency and regularity of activities. As a further criterion these are compared with the activities outside the state to determine taxability in New York. In the case of many foreign corporations, particularly holding companies, activities may not be continuous or frequent or regular and this criterion may not be final. Such a corporation might then land in the taxable class under another criterion, the purposes for which the corporation was organized compared with its activities in New York.

It is the policy of the Tax Commission to make periodic investigations to determine whether any foreign corporations are doing business in New York and not filing tax returns. Directories in office buildings are scanned for this purpose, as are telephone directories. Any newspaper publicity concerning a foreign corporation becomes a lead to the ever vigilant Commission.

Calendar and Fiscal Years

The law and regulations permit the filing of reports on a calendar year basis or on the basis of a fiscal year ending on the last day of any month other than December. The calendar year basis is required if the corporation does not keep books, or if it keeps books on the basis of any period ending on any day other than the last day of a calendar month.

If a taxpayer changes its basis from a fiscal year to a calendar year, it is required to file a return from the close of its old fiscal year to the following December 31st. If the change is from calendar year to fiscal year, a return is required from the close of the old calendar year to the close of the new fiscal year. The regulations (Article 210) state that for purposes of the franchise tax the same basis is required as the taxpayer uses for federal income tax purposes. Since the franchise tax is imposed for all or any part of each calendar or fiscal year, a corporation that dissolves, merges, consolidates or otherwise surrenders its charter is subject to a tax for the period from the close of its last fiscal or calendar year to the date of dissolution.

A corporation may cease to be taxable under Article 9A because of a change in classification. For example

a change in its activities may require it to be taxed as a real estate corporation. In this situation, too, a final return as a business corporation will be due for the period up to the date it ceases to be subject to tax under Article 9A.

Computation of Tax— Entire Net Income

While entire net income may be the basis for the tax, there are important adjustments by way of additions and deductions that are permitted. The law and regulations state that entire net income is presumably the same as the net income which the taxpayer reports for federal income tax purposes with certain enumerated adjustments. Subsidiary income is excluded entirely from entire net income. The principal item of this kind would be dividends on stock of corporations in which the parent company owns a majority of the stock. Excluded also is fifty percent of all dividends on stock in which the ownership is less than a majority.

Capital gains on subsidiary capital would like wise be deducted. The deduction for the franchise tax itself requires an adjustment. Under the federal law the franchise tax computed on the current report being prepared is deductible on the accrual basis. Under the franchise tax law this is not an allowable deduction in arriving at entire net income, but the franchise tax based on the period immediately preceding the period covered by the report is deductible. The credit allowed against the federal income tax under Section 31 of I.R.C. for foreign income taxes is allowed as a deduction in arriving at entire net income, provided such taxes are allocable to income being included in entire net income.

Income exempt from federal income tax, such as interest on state and certain federal obligations, is not exempt from franchise tax. Such income is thus added to entire net income. The franchise tax law does not allow a deduction for net operating losses of other years. Since gains on subsidiary capital are not includible in entire net income, losses likewise must be eliminated from the tax base.

Foreign corporations organized outside the United States are not taxed federally on income from sources outside the United States, but for franchise tax purposes such income must be included in the tax base of entire net income. Consequently some portion of such income will be allocated to New York under the allocation formula and subject to franchise tax.

A Word on Accounting Methods of Reporting Income

The law and regulations of course approve the accrual or cash basis of reporting income, and the Commission generally requires a taxpayer to use the same basis used for federal income tax purposes. However, in the case of building, installation or construction contracts, the Commission for years has looked with disfavor on the method used by many taxpayers, and acceptable by the federal taxing authorities, of reporting such income on the completed contract basis. Under old Article 9A it was possible for such a taxpayer to work on a contract for several years, pay a minimum franchise tax each year and in the year of completion of the contract when the profits would be reflected, dissolve before November 1, the beginnig of the old privilege year, and thus avoid substantial taxes. While this type of avoidance is no longer possible, the Commission may under the law (Section 208.9(d)) and the regulations (Article 313) determine the year in which any item of income or deduction is to be included, regardless of the method of accounting used by the taxpayer. This it will do in the case of taxpayers in the construction business reporting on a completed contract basis by requiring such taxpayers to report the income on the basis of percentage of completion in each year.

Returns Covering a Period of Less than Twelve Months

Taxpayers, particularly foreign corporations, under a 1945 amendment in the law are given equitable treatment in this situation. This provision of the law is usually applicable to a foreign corporation that qualifies to do business in New York some time during its fiscal or calendar year, say March 1, 1946. Assume that the corporation had filed its federal return for 1946 on a calendar year basis and reported a net income of $70,000. After making the relevant adjustments to determine entire net income for franchise tax purposes, the tax base is then prorated for the ten month period, by getting the average monthly income and multiplying this by ten. This of course results in a lower tax base.

The latter adjustment is also permitted where the tax is to be computed on business and investment capital. The rate of tax is one mill on each dollar of total business and investment capital allocated to New York. The values to be placed on such capital are average fair market values of the net assets used in the business, prorated to the period of time covered by the report.

The Tangible Property Factor in the Allocation Formula

A taxpayer who has a regular place of business outside New York will not be taxed on 100% of its entire net income. On the basis of an allocation formula a portion of the income will not be taxed, the law thus giving recognition to the fact that the taxpayer is doing an interstate business that should not be subject to tax by New York. One of the factors in the allocation formula is real and tangible personal property. Actually, the ratio of such property in New York to all such property becomes one of the percentages that will determine how much of entire net income will be allocated to New York.

The regulations provide that only property owned by the taxpayer is considered in determining this precentage. There is no attempt to define real property. It may thus become important for a taxpayer who does not own real property, but who leases and improves it to know whether the value of such leasehold and improvements are to be considered as real property. The taxpayer who gets a tax benefit from the exclusion of such an item from the allocation formula will of course not be too deeply concerned. But occasionally the Commission spots a situation where it would like to include such an item in the property to be allocated to New York. In such a case it should be noted that it was the intention of the tax advisory group that worked on new article 9A to exclude leaseholds and improvements from the property factor. In the last analysis the taxpayer would have to rely on the general law of real property for a determination of what the term includes. If the term were broadened in order to increase the New York allocation fraction it could easily boomerang and cause the Commission much grief in those cases where a taxpayer leases real property outside New York and thus is enabled to reduce the percentage of income allocable to New York.

Interstate Commerce—Gross Receipts Tax

Several weeks ago the New Mexico Supreme Court rendered a decision in the case of *Albuquerque Broadcasting Co. v. Bureau of Revenue* on the issue of the extent to which a state may tax interstate activities. The opinion is especially interesting in that it reviews the important U. S. Supreme Court cases on this issue decided in recent years. The tax involved was one on the gross receipts of any person engaged in the business of conducting radio broadcasting stations. The court held that the state could not tax all the gross receipts. To do so constituted an undue discrimination against interstate commerce. Only receipts attributed to local broadcasts are taxable and those con-

sisted of local advertising broadcasts which originated locally but were heard without the state. Non-taxable were receipts from programs emanating outside of New Mexico and picked up by the radio station from telephone lines; and also national advertising programs broadcast by means of transcriptions by wire pick up from without the state, and from records sent from without the state.

The court held that local advertising constituted intrastate business or that the advertising of local business to secure local business was a taxable event that could be reached by the state.

New York City Real Estate Tax—Accrual Date for Income Tax Deduction

The accounting concept of accrual is at variance with the legal and tax concept. When real estate is sold, an adjustment is customarily made between buyer and seller for real estate taxes based upon the accountant's concept of accrual. From a tax standpoint the deduction for such taxes depends upon the date the legal liability for the tax accrued. After much litigation on this point the Supreme Court finally ruled that the tax accrued when it became a lien or when the owner became personally liable for the tax (*Magruder* v. *Supplee* 316 U. S. 394). Therefore, if the buyer paid the tax after such date he could not take a deduction for it. Such payment as to him represented a capital expenditure by way of an additional cost of the real estate he purchased.

In a recent Tax Court case (*Adda, Inc.* v. *Commissioner*, 9 T.C. 33), the Court held that the New York City real estate tax becomes a lien when due and payable. In this case the buyer purchased the property on August 5, 1940. He paid the tax for the fiscal year July 1, 1940 to June 30, 1941 in October 1940. The lien attached on October 1, 1940, and so the buyer could accrue the entire tax, since he owned the property on that date. Presumably the state would follow the same rule.

Interest on Delinquent Franchise Taxes—Union Fabrics, Inc.

In this case, the State Tax Commission had filed a claim in bankruptcy for franchise taxes due. The referee had allowed interest on the claim from the due date to date of payment. On review it was held that interest should be allowed only to the date of filing the petition in bankruptcy. Where the power to pay is suspended by law, no one should gain or lose by the delay. That apparently is the general bankruptcy rule.

When Does the Franchise Tax Accrue as a Deduction?

Last month we discussed the *Durst Production Corp.* case (8 T.C. #158) which held that the franchise tax under new Article 9A accrued at the close of the base year, which measures the tax, at least for the transition years 1943 and 1944.

In a subsequent Tax Court case, *Central Investment Corp.* (9 T.C. #17), the Court holds that the California Franchise tax accrues during the privilege year, even though it is based upon income of the preceding year. This decision appears to overrule the *Durst* case. In the *Central Investment* case the Court held that no liability for the tax is incurred until the taxpayer actually does business during the privilege year. In the *Durst* case, however, the Court held that the tax based on income for the fiscal year ended May 31, 1944, accrued on the last day of that year rather than on November 1, 1944, the first day of the privilege period for which the tax was paid. It should be noted in this connection that the 1944 change in Article 9A provided for a dissolution tax which would have subjected the taxpayer to a tax in the same amount had the taxpayer dissolved at any time after May 31, 1944. It is probably this factor that led the Tax Court to decide in the *Durst* case that the tax accrued on May 31, 1944, instead of on November 1, 1944. Both decisions could have set forth this distinction more clearly. Instead the opin-

ions are quite hazy on this point and taxpayers will remain in a state of uncertainty until another case comes along for further clarification.

When Is Income from a Partnership Taxable? Calendar or Fiscal Years

Husband and wife had been filing joint returns on a calendar year basis. On April 1, 1946, the husband forms a partnership with B. The partnership adopts the fiscal year basis for reporting income, its first accounting year being for the period ending March 31, 1947. Up to the date of the formation of the partnership both husband and wife were employed and received income in the form of salaries. How would they report their income for 1946 and 1947?

For the year 1946, husband and wife would be taxed only in their salaries, the husband on the salary he received up to April 1st and the wife on whatever she received during the year 1946. A partner is taxed on his distributive share of the net profit of the partnership. If the partnership is on a fiscal year basis the partner is taxed on his distributive share of the profit of the partnership for the fiscal year ending within his calendar or fiscal year. Consequently the husband will not be taxable on any income from the partnership for the year 1946, but in 1947 he will be taxed on his distributive share of the partnership profits for the period from April 1, 1936 to March 31, 1947.

A further question is asked: Suppose the partnership dissolved on March 31, 1947, and the husband continues the business as a sole proprietor. How would the husband report his income from the sole proprietorship?

Since the hubsand is on a calendar year basis he would report the income from the business for the period from April 1, 1947, to December 31, 1947, in 1947. The sole proprietorship does not have the partnership's fiscal year. If the hubsand wished to adopt a fiscal year for the business he would have to obtain permission to change his basis for reporting income from the calendar year to the fiscal year. It should be noted that under the facts stated the husband in 1947 would be taxed on his share of the partnership which covered a full year's operations plus his income from the business for the next nine months.

Accounting at the S.E.C.

Conducted by William W. Werntz

Accounting rules and regulations of the S.E.C. are rarely promulgated until after the Commission has first made public a draft of the rule and invited the submission of comments by all interested. Officials of the Commission have many times urged accountants to participate in the rule making process by commenting, orally or in writing, on both the substance and draftsmanship of staff proposals. More important, they have urged accountants to make recommendations from time to time for desirable additions or changes. Some accountants have done this on their own initiative. A good many more have done so as a result of specific requests addressed to them, usually by the Chief Accountant. There has, however, been a tendency in recent years to leave all such matters to committees of the national and sometimes the state societies. Such committees have always given generously of their time and effort and the Commission has again and again called attention to the importance and value of their contributions.

Committee comments, however, sometimes lack the flavor and fervidness of comments by an individual who has given a problem some thought or grappled with an issue in a particular case. A letter of comment or recommendation from such an individual, stating in as succinct a way as possible the particular reasons for his approval or disapproval of a Commission proposal or for the suggestions being made, can be an important and very useful part of the rule making process—and the reasons given are generally much more important and helpful to the Commission than a mere statement of agreement or disagreement.

Accountants, we think, ought to take greater advantage of such invitations, both as a public service and in the interests of their profession.

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Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

* * * *

The most interesting development of recent months was the release on September 25th of the Commission's findings and opinion in the matter of *Globe Aircraft Corporation,* Securities Act Release No. 3255. A registration statement covering preferred stock of that Corporation became effective on March 18, 1946, and the securities were sold within two or three weeks thereafter. The present proceedings cancelled the effectiveness of the registration statement. In the interval the company, as a result of an involuntary petition, had been adjudicated a bankrupt and its assets had been sold by the trustee. If nothing else, the case gives point to the fact that the Commission neither approves nor disapproves securities registered with it under the 1933 Act. All kinds and grades of securities can be and have been registered. Contrary to statements sometimes found in print, if the required information about a security appears to be fully and fairly set forth, the Securities Act provides no basis on which to prevent its registration and sale, no matter what the

conviction of the administrative body may be as to the merits of the investment. Appraisal of the risks and of the opportunity offered are fortunately left in the prospective buyer's hands. Moreover, while the papers filed are examined with a view to finding and having corrected any apparent inaccuracies or omissions, this process supplies no absolute assurance that statements and data, valid on their face, may not actually be misleading or untrue. The basic responsibility for fairness and accuracy of presentation still rests on those who should best know the facts — the issuer and its officers and directors, together with those who permit their names to be used as experts.

The issues in the *Globe* case were three: first, whether the reporting of a loss of approximately of $17,000 for the month of January, 1946, was misleading due to a failure to disclose the possibility that additional losses were inherent in the closing inventories; second, whether the information as to certain notes payable was misleading because of failure to disclose that the amount had increased by some $200,000 at the effective date over the amount at February 6, 1946, the latest date at which an amount was given for such notes in the registration statement; and third, whether a misrepresentation existed in that the statement made as to the manner in which the proceeds were intended to be used was so at odds with the condition of the company that the company could not have intended so to apply the proceeds.

For the present, we confine ourselves to the first issue, since the others are of less direct significance to accounting, as such.

The registration statement included certified income statements for the years 1943, 1944, and 1945. In addition, statements for the 4 months ended December 31, 1945, and for the month of January, 1946, were set forth as part of the description of sales and earnings. The 4 months' statement was introduced by this language, "The figures . . . in the statement of income for the four months ended December 31, 1945 have been taken from the audit (sic) statement of income presented herewith by . . . ., independent public accountants, and are subject to and should be read in conjunction with that statement, the notes thereto, and the accountants' certificate." For the year 1945 as a whole, a profit of $398,855 was shown; for the last four months of 1945, a loss of $541,604 including therein (as shown in a footnote) an inventory write-down from "cost" to "replacement" value of about $439,000. Of the $439,000, it appeared that $56,000 represented excess of cost of raw materials over replacement value, $39,000 represented excess of cost of tooling over replacement value, and $344,000 represented excess of cost of work in process over replacement value — the latter figure being arrived at by comparing with Globe's cost of production the average prices charged by a subcontractor in manufacturing planes for Globe. The income statement for January, 1946, (unaudited) showed a loss of $17,000 and made no reference to the existence or non-existence of further losses on inventory.

The record also showed that a post-effective amendment was filed on July 1, 1946, giving supplemental income data for the month of February, 1946. Such amendment stated that the net loss for February "before adjustment to work in process inventory" was $19,752 and that the net loss "after adjustment to work in process at February 28, 1946" amounting to $267,248 was $287,000. The Commission's opinion goes on to say that:

> "The hearing officer . . . observed that the write-down of $439,000 was a recognition that Globe's manufacturing costs, at least for the last four months of 1945, 'were out of line and that the excess had to be considered as an operational loss.' He found that 'similar excess costs for work in process inventory continued to be incurred throughout January as well as February 1946,' and that the management was cognizant of such costs, which were

subsequently recognized as losses in the company's accounts, but with respect to which there was no disclosure either in connection with the January statement itself or in any other part of the registration statement. The hearing officer concluded that an adequate exposition of the company's earnings should have included, at the very least, a footnote disclosing that the January statement, unlike the statement for the last four months of 1945, did not include provision for inventory losses which, although then not precisely determinable, were probably inherent to the same relative extent as shown at December 31, 1945."

In approving the hearing officer's findings the Commission said:

"(the underwriters) contend that under accepted accounting principles it was not required that a further write-down be made of inventory at the end of January. Participants challenge the hearing officer's conclusion that the inventory write-down represented an operational loss on the ground that an actual profit or loss depends upon the price at which the planes manufactured from the work in process inventory are ultimately sold and not upon the replacement cost of the inventory.

"These arguments, however, do not refute the basic principles underlying the hearing officer's conclusion that it was materially misleading to omit any reference to inventory losses in the January statement. The question here is not whether from an accounting standpoint there should have been an actual inventory write-down in January, but whether the existence of additional inventory losses of which the management was cognizant, should have been disclosed. A full and fair presentation of the company's financial status would have required that this condition be brought to the attention of investors. Similarly it is immaterial whether or not an inventory write-down is viewed as an operational loss. The significant fact is not whether the loss has in fact been actually realized by sale, but that the loss has accrued and is inherent on the basis of the company's current operations. The fact, pointed to by (the underwriters), that Globe in a statement of income and earned surplus for the two months ended February 28, 1946 (not contained in the registration statement) which showed January and February profit and loss figures separately, reflected an inventory write-down only for February, is not proof that no inventory losses were properly attributable to January. This statement merely shows that the losses inherent in January were formally recognized by the company as of February 28, 1946, and, as already indicated, the propriety of making an actual write-down on the company's books is not determinative of the adequacy of the disclosure made in connection with the January statement.

"The question here is not one of accounting procedure whereby a corporation makes certain accounting adjustments at specified times thereby giving formal recognition to the cumulative effect of prior operations. Our inquiry is directed to the problem whether, in connection with the public offering of securities, adequate disclosure of the company's financial condition is furnished if the company merely shows the carrying value per books of its inventories without indicating the existence of losses inherent in its operations due to non-recoverable costs incurred in acquiring those inventories. We do not believe that under such circumstances the disclosure standards of the Securities Act are met where investors are presented with financial statements which merely reflect the carrying value of such inventories without disclosing that such carrying value contains costs which on the basis of present indications would not be recovered. The failure to disclose the existence of such facts creates a misleading picture of the company's position and operations.

"Moreover, the possibilities for misleading investors in this respect were greatly emphasized by the fact that the figures for the last four months of 1945 contained specific reference to inventory losses for that period; the obvious implication from the failure to make any reference to such losses for the month of January 1946 was that there were no similar losses in the latter period. As we have indicated, this implication was wholly false."

The published material includes both the hearing officer's recommended decision and the Commission's formal opinion reached after both sides had an opportunity to criticize the hearing officer's proposed decision. With minor exceptions, the Commission adopted the recommended opinion.

On the basis of the Commission's findings (1) that a loss existed; (2) that a large part of the loss was attributable to January operations; (3) that the company knew of the probable loss; and (4) that the amount involved was material, there is no escape from agreement that the reporting of a January loss of $17,000, with no disclosure or

even comment on the inventory situation, was improper as a matter of accounting principle and as a matter of sound reporting technique. It is noteworthy that the audited statements reflected and disclosed an inventory write-down, whereas the unaudited statements were silent on the point. The opinion's criticism is thus directed only at the January unaudited figures. It further appears, however, that the December write-down was effected following conferences with the Commission's staff beginning in February of 1946.

A point of particular interest in the opinion is its rejection of the argument that any write-down of inventory would be largely offset by a resulting claim for tax refunds and would thus be relatively immaterial. To use figures: There was testimony in the record that at least $100,000 of the February write-down was applicable to January and there would be a probable tax refund of *72%* of that amount. On that basis, the loss from operations in January, on sales of about $670,000, would have been $117,000 before giving effect to a related tax refund of, say, $72,000. It would seem pretty clear that disclosure of the larger operating loss and the offsetting tax adjustment gives quite a different slant to the month's business than does a statement in which only the net effect is shown, or one in which (as in the instant case) both the write-down and the refund are omitted from consideration. Even an undisclosed offsetting in such a case comes perilously close to the prohibition established in the *Kylsant* case of unhappy memory.

The Taxpert

By Lewis Gluick, C.P.A.

Last *night* Mrs. Gluick served meat-loaf for dinner. It tasted good. Mrs. G. is an excellent cook. But when we raided the icebox at eleven ten last night and ate some of it cold, it tasted even better. So this morning, with deadline approaching and current cases scarce, we raided our files and herewith present the cold left-overs. Let us know how you like them.

Information Please!

Something new to the Shoptalker is the "owelty" found in the case of *Meyer,* 46-1 USTC §9128 and 46-1 USTC §9332 (Orphans' Court, Allegeheny County, Penn.) What does it mean? Our dictionary does not have it. But our memory does recall the old yarn about a Cockney in the Canadian forests. A shriek pierced the night. "Wot's that?" queried the Cockney, trying to show no fear. "That's an owl," said the native. "I know," said the Cockney, "but 'oo is 'owling?"

In September, 1932, the Shoptalker reviewed a book by H. F. Taggart entitled "Realty Leases & Income Taxes". We expressed a favorable opinion of it. Will somebody tell us if it has been brought more nearly down to date? If the publisher will send us a recent edition, we will not only appreciate it, but pay for it. If there is any other *recent,* authoritative text on the subject, please tell us. We need it.

Do You Know What You're Talking About?

One of the funniest scenes we ever saw in the movies was over 20 years ago. Buster Keaton was supposed to be delivering an oration at a High School Commencement. His subject was the value of education. But before he started there had been an accident, and when he came to the line, "Where would I be without my books?" the audience howled, for at the moment he was using a pile of books to conceal a vital gap in his nether garments.

But lawyers and accountants may well ponder that question. Could we practice at all if it were not for the loose-leaf tax services? And still more, we should ask, "Are we getting enough out of them?" We recently heard a story of a well established public accountant who, despite subscriptions to two large services, made a huge error in filing a tax return for a client. Payment of penalties forced the client out of business, according to our informant. We sympathize with the accountant. "There, but for the grace of God, go I" is one of our favorite quotations. Still further, do we really know what we are talking about? Do you have the dictionary habit? Or do you just leave it to your typist to use the lexicon as a speller? Some of the most common words have nice meanings which may have eluded you, and derivations which may astound you. Look up *mathematics* for example. For that matter, look up *nice,* in its original sense.

Many years ago we noted in the Shop that a person could tell just by looking at the professional library, whether a taxpert were a lawyer or accountant. The former's Code volume would be the most smudged and dog-eared; the latter's Regs would show the most use. We need to stick to foundations; the basic elements. We cordially recommend to some publisher that he start work on a *"Dictionary* for *Taxpayers"*.

Lewis Gluick, C.P.A., has been a member of our Society since 1924. He is now engaged in practice in Long Beach, California. He is best known as the Shoptalker, under which name he has been writing since 1928.

It might be produced in five years. Meanwhile, make more use of your Webster, Winston and Funk.

Withholding

The case of *Grasso* v. *Oehmann,* decided on July 25, is required reading for all students of Federal Taxation, and excellent review for practicioners. Judge Clagget of the Municipal Court of Appeals of the District of Columbia gives a lucid exposition of the trustee theory, the penalties and the remedies (47-2 USTC §9337).

Bad Debts

One Monday, about 4 months ago, we attended the regular luncheon of the Los Angeles C.P.A.'s. The guest speaker's topic was "Bad Debts". He high-spotted some of the many tax complications involved therein, and advised us all to study them diligently, for we are going to need them next tax season. For over five years the subject has been of little importance. A business recession is under way. We should be prepared for it. And some people are really preparing. A salesman for a law reporting publisher told us, the day before we wrote this, that he had made more sales of his company's "Bankruptcy Service" within the month, than he had of that service, in the preceding three years.

"Coming events cast their shadows before."

The Big Trek

The boosters of Southern California have derived intense satisfaction from the huge increase in population which the "Southland" continues to make. They particularly like the movement of industry to this area. To hear them tell it, it is due entirely to the climate, with a few minor factors, among them taxation. Our own opinion is that taxation was a major factor. If a few more big industrial states like Pennsylvania adopt community property, the movement will taper off.

Last spring we were called upon to make a calculation which, we do not doubt, other C.P.A.'s have made. A high powered business-getter demanded a salary of $25,000., net of Federal Income and all Social Security taxes. He was married, with no dependents. Our calculations showed that in Illinois, or any other non-community property state, the corporation employing him would have to pay $48,364. Whereas, in California, or other community property state, his gross salary would have to be only $35,790. In other words, he would lose nothing and the corporation would save nearly $13,000. Take a *big* corporation, with many officials, some getting upwards of $100,000 and climate becomes secondary. If the nature of the business permits, Texas is even better. Like New Jersey, that blessed state imposes no personal income tax.

But what has amazed us for 25 years, and continues to do so increasingly, is why Florida is not a community property state. Her proud French and Spanish inheritance qualifies her, by blood line, to have community property. Pennsylvania and Michigan have it only by artificial adoption. After her recent sad experience with a hurricane, Florida needs new capital. Community property would go far towards attracting it.

Human Interest

A case that has human interest to an unusual degree is that of the *Estate of Harvey Fleming,* of San Diego. It is reported in full in the CCH Inheritance, Estate Gift Tax Service at paragraph 16,168. It is no unusual thing for a man to endow college scholarships; nor to set up a competition for the selection of the scholars. Such competitions normally range from over-all high stand in entrance examinations to the composition of a Latin ode. But always learning, general or specialized, is stressed. Not the late Mr. Fleming! He provided for selection of scholars by *a golf tournament* to be held each year in San Diego County. And the court upheld it!

This city of Long Beach, in which

the writer has resided for nearly three years, has long been known as "the seacoast of Iowa", it having been settled mainly by people from "the tall corn state". Why people still continue to come here is shown by the case of *Miller* (CCH I.E & G. Tax Service, par. 16,158). The Millers, originally residents of Iowa, moved to California in 1921. It was held that real property purchased in California with funds originating in the husband's home state earnings, was nevertheless community property, and taxable as such.

PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

Depreciation and Replacement Cost Problems

A particularly current problem, whose gravity is accentuated by the approach of the year-end and the preparation of the annual financial statements, is the question of what is the proper depreciation policy to pursue therein in view of the general and serious rise in price levels. A concomitant question involves the treatment of excess plant costs incurred in present expenditures for fixed assets at prices substantially higher than pre-war levels.

It has long been recognized by accountants that the accounting for fixed assets should normally be based on cost[1] and that the theory of depreciation accounting is designed to allocate, in a systematic and rational manner, this cost of a capital asset to the periods wherein it is estimated that the facility it represents will be utilized; it is not usually intended that this procedure shall provide the funds with which to keep the physical asset intact.

A pricing policy need not and today probably does not depend upon a built-up unit product cost.[2] Accordingly, in these times management undoubtedly takes the factor of depreciation upon appreciated values into consideration in fixing prices. And that is where the difficulty arises: the profits are greater by the amount of this factor added to the price, without any corresponding deduction in cost.

As Carman G. Blough said:[3]

> "Stockholders are hard to convince that increased profits should not be distributed as dividends; labor increases its claims for compensation; political demagogues harangue on the excessiveness of corporate income; and enemies of our political order use it to stir up prejudices against private enterprise."

Various studies of this problem have recently been reported in current periodical literature,[4] and should be required reading for those interested in the problem.

The Committee on Accounting Procedure of the American Institute of Accountants recently gave extended consideration to this subject and, because of its importance and the consequent need for an immediate expression thereon, prepared the following statement on the subject for release:

> "The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.
>
> "The committee recognizes that business management has the responsibility of pro-

[1] Accounting Research Bulletin No. 5; April, 1940.

[2] "Price and Cost", by James L. Dohr; The Journal of Accountancy, January, 1947; pp. 11, 14. "Selling Overhead to Inventory", by Philip Kramer; N.A.C.A. Bulletin, January 15, 1947 (Sec. One); pp. 587, 592.

[3] "Current Accounting Problems", Edited by Carman G. Blough; The Journal of Accountancy, October, 1947; p. 333, 334.

[4] "The Postwar Problem of Capital Replacement"; The Guaranty Survey, pp. 1-4, Vol. XXVII, No. 6; September 24, 1947. "Preserving the Integrity of Equity Capital", by H. T. McAnly and Wm. T. Sunley; The Controller, October, 1947; pp. 509-12, 536, 538. "Replacement and Excess Construction Costs" by Carman G. Blough; Current Accounting Problems, *supra*. "Provision for High Replacement Costs", in Cost Currents, N.A.C.A. Bulletin, Section Two; October 15, 1947, at p. 253. See, also, "Property Accounting", by Samuel J. Broad, in The Controller, for January, 1947.

viding for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

"When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

"It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

"It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

"The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

* * *

Results of Business Survey

On August 29, 1947, the Credit Planning Committee of the New York Credit Men's Association distributed a questionnaire to all members containing nine questions designed to reveal economic thinking of credit and financial men in New York. Approximately 500 responses were received.

The results and analyses of that survey are herewith presented:

QUESTION 1. *Were the number of customer business failures greater in your trade from January 1, 1947 to September 1, 1947 than for the same period in 1946?*

In answer to this question, 60% of the credit executives responding stated that customer business failures were greater in the eight-month period of 1947 than for the corresponding period of 1946. Poor management and excessive inventory were the two predominant factors listed as responsible for this condition.

Other reasons given were lack of capital, high prices, and reductions in government contracts and subsidies as compared to the war period. Relatively few of the reasons for failures indicated reduced profits or inferior merchandise as possibly having any bearing on failures.

QUESTION 2. *Do you now expect increased failures or fewer failures?*

93% of the responding credit executives anticipated an increased number of failures.

QUESTION 3. *Do you now expect a business recession, a depression, or an improvement in business?*

Although the general economic pattern shows a stability, it is believed that seasonal variations and cyclical fluctuations will become increasingly sharper. Thus, this question is, and rightly should be, of paramount interest to credit and financial executives.

80% expected a business recession to begin in the second quarter of 1948. The predominant reason given was high prices. Excessive inventory and purchaser resistance followed closely behind. Lack of capital, high taxes, and labor unrest were cited by only a few of the members as contributing factors.

Exceptional to this trend were the iron and steel and construction and building materials industries where there have been fewer failures and an overwhelming negative re-

sponse to anticipated failures. Credit executives now expect a boom in these fields because of long unsatisfied domestic and foreign demand.

QUESTION 4. *Are collections slower, better, or the same as in December 1946?*

95% reported that collections were slower than in December of 1946. When surveyed in November of 1946, manufacturers of wearing apparel and allied merchandise, factors, converters, and textile manufacturers and distributors reported in large majority that the collection trend in their trade had not yet turned downward to any serious degree. However, this category, which represented approximately 25% of the total replies, now indicates a definite slow-down in collections. The reasons given for this trend were high prices, excessive inventory, purchaser resistance, lack of capital and discontinuance of cash discounts. The slowing of collections was reported unanimously by all industries and services reporting.

QUESTION 5. *Has the trend toward the elimination or reduction of cash discounts in your industry continued, stopped, or have previous discount terms been reinstated?*

82% reported the continued elimination or reduction of cash discounts. The number of establishments reporting a reinstatement of previous discount terms has been negligible.

QUESTION 6. *In December 1946 many trades reported purchaser resistance and cancellation of orders and future commitments. Is there today continued customer purchaser resistance; cancellation of future orders, larger orders and future commitments; unfilled backlog of orders?*

65% reported customer purchasing resistance with only 30% reporting cancellation of future orders. Slightly over one-half of those reporting indicated an unfilled backlog of orders. However, these orders would seem to represent previous commitments, as 63% stated that orders and future commitments were now much smaller.

QUESTION 7. *The "Survey of Current Business" reports that inventories of all firms (except agriculture) increased $300 million in book value during May 1947 (a total increase from $22.1 to $22.4 billion to that date). Do you consider this increase in inventories to be a favorable or unfavorable trend creditwise?*

80% believed the increase in inventories to be an unfavorable trend creditwise because it is an increase in dollar value rather than an increase of actual physical inventory. The dangers of over-valuated inventories are obvious and credit executives feel that purchaser resistance induced by high prices will continue until the price structure achieves a new equilibrium, thereby deflating the value of present inventories.

QUESTION 8. *Are you finding that customers who willingly issued financial statements during the war period are reluctant to do so now?*

By a ratio of more than two to one, it was reported that financial statements are issued as readily now as during the war period.

QUESTION 9. *International trade.*

60% of the reporting members are now exporting. 85% of those firms not engaged in the export field do not anticipate entering it. Of those now engaged in export trade, there was an almost even split of opinion as to whether sales volume will increase or decrease. Only about one-third contemplated the extension of longer credit terms; however, relatively few thought of reducing present export credit terms.

* * *

In evaluating this poll, consideration should be given to the fact that it reflects conditions which existed at the time the questionnaire was mailed on August 29th. Changes may have occurred since then to alter some of the conclusions. These results do not necessarily represent the opinions of the Credit Planning Committee nor their firms.

* * *

Cost Control for Motor Carriers

Allen C. Kahl presents an interesting case study of the use of costs of motor operations for managerial purposes in Section One of the October 15, 1947, issue of the N.A.C.A. Bulletin.

The use of statistical data with respect to costs and revenues per mile is considered, as is the related problem of expense analysis. Detailed schedules of Truck Income and Expense (by Truck) for each month, and cumulatively for a year, are presented as accompanying exhibits. A cumulative monthly operating summary is also included.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

The accounting and auditing research bulletins issued by the American Institute of Accountants are beneficial to the profession and serve a necessary purpose in codifying accepted accounting theory, and in narrowing the prevelant differences of opinion.

May I, however, offer the following comments relating to item 4 on page 248 of bulletin No. 30, which was released last week.

The bulletin states that current assets are " . . . those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." In illustrating the definition, item (b) includes "ordinary maintenance material and parts" and item (g) includes "prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which if not paid in advance, would require the use of current assets during the operating cycle."

The quoted sections (b) and (g) are, in my opinion, not representative of sound accounting practice and would not be viewed with approval by bankers and other credit grantors. My objections, in addition to those which would be advanced by a credit grantor interested in the realization value of current assets, are summarized as follows:

Regarding Section (b):

Maintenance parts and supplies, in the cases of industrial corporations with large plants, coal mines, railroads, office, loft, or apartment buildings, etc., represent items ranging from electric light bulbs wiping rags, cleaning supplies and small machine parts, to such items as replacement beams and steel girders, as well as large tool and equipment spare parts.

Obviously these items will not be realized in cash during the coming year and, in fact, may often represent several years' supply. Also, since many of these items will be used in repairing fixed assets, it does not seem proper to classify them as current assets.

Regarding Section (g):

Including an item as a current asset because "if it had not already been paid for it would require the use of cash in the following period," is, in my opinion, poor reasoning and substitutes an assumption for a fact.

General:

The reasoning in Bulletin No. 30 will help to demolish the line of demarcation between the "present value" theory governing the valuation of current assets, as distinguished from the "original cost" theory used in valuing fixed assets. Also, if this reasoning is followed through, we may see the coming year's depreciation deduction carried as a current asset on the theory that it enters into the cost of production and so into inventory, and thus is consumed in the normal operating cycle of the buiness.

Very truly yours,

STEPHEN CHAN, C.P.A.

New York, N. Y.,
September 18th, 1947.

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STEPHEN CHAN, C.P.A.

New York, N. Y.,
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BOOK REVIEWS

Industrial Accounting,

By Samuel Waldo Specthrie. PRENTICE-HALL, INC., New York, 1947. 395 pages, $4.00.

The author states that his book was written as a text for business administrators, engineers, and engineering students who might want to obtain an understanding of the processes and executive uses of industrial accounting.

To accomplish his purpose, the author devotes fifteen chapters to basic accounting principles and bookkeeping procedure, five chapters to the main features of corporation accounting, fourteen chapters to cost accounting theory and procedure, and the last three chapters to the use of accounting in administering a business.

The purely clerical work incidental to accounting study is kept to a minimum. The presentation of accounting principles consists of recording the ordinary transactions of a trading business, making closing entries, preparing financial statements, and using control accounts and subsidiary ledgers. The chapters devoted to corporations explain some of the accounting, legal and financal problems involved in the capital stock, earned surplus, capital surplus, dividends, and bonded debt of a corporation. The chapters on cost accounting discuss cost finding, accounting for material, labor and burden in job lot, process and operational cost systems, and the uses of standard costs. The last three chapters set forth the executive uses of accounting data for control of business expense, the measurement of operating results, and the formation of business policies.

A surprising amount of material is explained by the author in a panorama of many varied fields of accounting. It is difficult to say, however, whether a reader, unfamiliar with accounting and bookkeeping procedure, will learn much from the presentation of accounting principles, other than there are certain books of account in which transactions are recorded. This is not because of faulty or poor writing, but because of the difficulty beginners generally experience in learning accounting without extensive explanation and drill. With many diverse topics to cover, the author could not devote too much space to any one.

Exception may be taken to some of the author's statements and explanations. Examples are his statement that the fact of posting is denoted by a check mark in the ledger folio column, and the one that, in arriving at the balance of an account, debits and credits of equal amount are subtracted. The illustration of footing and balancing an account could be improved typographically. Dollar signs should have been omitted from all accounts. Occasionally, terms such as footings, receivables, fixed assets, etc. are used without being explained or defined, or, if the explanation is given, it appears a page or more after the illustration. The illustration of a balance sheet omits a line at the bottom of a column of figures to separate the details from the total of the column. Likewise, from the viewpoint of law, one may question the author's general statement that a dividend may not exceed the balance in earned surplus. In New York, a court decision is definitely to the contrary. Then again, keeping in mind the background of a likely reader, one may question the advisability of crediting profit and loss to set up a profit, although it is clear to a practitioner that the entry suggested served to show the ultimate effect of profits on the books of account. From a tax viewpoint, one may again take exception to the statement that stock

dividends are not income to the recipient shareholders. For tax purposes some dividends are deemed to be taxable.

It is difficult to say whether one who has never been exposed to accounting and bookkeeping will benefit from reading the text. To have covered all the topics discussed in a thorough manner would have required a volume many times the size of the one under review. One should keep in mind that the author was writing for business administrators and engineers, as well as for engineering students. Perhaps he assumed that those in the first two classes, because of their experience and work, would be familiar with some bookkeeping processes. For them, the chapters setting forth how some basic entries are made could have been eliminated. For those in the last class, the presentation of this material, in the reviewer's opinion, will not be too well understood.

Some chapters are excellently written, particularly those on the corporate net worth, and the nature and uses of cost accounting. The author's presentation of the use of accounting in administering a business should be of material use to a reader in pointing out how books of account, and the information they contain, can be put to intelligent use in control and operation, and in the formation of business policies.

While it is understandable that the introduction of too much detail would have destroyed the purpose for which the book was written, it is to be regretted that necessary explanatory matter was omitted in some vital spots. Additional problem material could also have been made available for those readers who were learning about accounting for the first time.

Despite the shortcomings pointed out, the author has made available a streamlined volume on accounting which has definite merit and will be of use to executives who desire some information on corporations and costs, and who are responsible for planning and operating a business.

STANLEY B. TUNICK

The School of Business and Civic Administration,
The City College of New York.

Cost Accounting Principles and Practice (Revised Edition),

By John J. W. Neuner, RICHARD D. IRWIN, INC., Chicago, Illinois, 1947. xviii + 874 pages, $5.00.

In this third edition of a book that is widely used as a textbook by collegiate schools of business, the author has accepted "the obligation to keep the text up to date in organization, in teaching methods, and in subject matter". He has very adequately attained these objectives. Cost principles and procedures are emphasized by the wide use of illustrative material such as statements, diagrams, forms, and journal entries. Each chapter is concluded with a series of carefully graded questions and problems which are completely new. As an aid to the student and teacher an innovation of merit has been made by preceding each problem with a statement of its purpose. In addition to the chapter problems complete job order, process, and standard cost sets appear at the end of the book.

The book which contains twenty-nine chapters is divided into two parts. The first part entitled, "Mechanics of Cost Accounting" covers in detail the fundamental concepts of historical cost accounting. Chapters are devoted to cost terminology, records, methods, and entries necessary to an understanding of the accounting for and control of material, labor, and manufacturing expenses.

Part two of the book "Specialized and Advanced Cost Accounting" logically leads the student who has been grounded in fundamentals into those areas of the subject which are either relatively new or pertain to the efficient operation and control of a business

enterprise. Chapters are devoted to budgetary control, standard costs, presentation of reports, graphs and analyses to management, and distribution and other non-manufacturing costs. Since this part of the book covers many fields which have been the subject matter of many volumes, the author is to be specially commended on his concise presentation.

While the author considers his book essentially a textbook on cost accounting, a study of it, particularly the second part, clearly indicates that it should be part of the reference library of every professional and private accountant. In addition some of the chapters like those on managerial reports and a re-examination of cost accounting might very well constitute important current reading to many practicing accountants.

George L. Nohe

O. F. Taylor & Co.
New York, N. Y.

Mathematics of Accounting, Third Edition.

By Arthur B. Curtis and John H. Cooper. Prentice-Hall, Inc., New York, 1947. x + 550 pages, $6.00.

Addition of new material makes the third edition of this work, first published in 1925 and revised in 1934, a most comprehensive treatment of the topics usually covered by a combination of "Business Arithmetic", "Commercial Algebra", and "Financial Mathematics". Part One, running to 307 pages, covers the arithmetic and algebraic topics, with Part Two presenting the financial and actuarial topics with appropriate tables in the appendices.

Throughout the book a wealth of well chosen problems offers ample opportunity for practice in the use of methods and formulas. For most problems, illustrations with detailed solutions, and explanations where necessary, serve as guides to learning and applying methods of solution.

The first several chapters of Part One are devoted to the fundamental operations of arithmetic, presenting much remedial material as well as short methods for performing and checking operations with integers, fractions, decimal fractions, and percentages. Chapters on Commercial Discount, Simple Interest, Bank Discount, Partial Payments, Averaging Dates of Invoices, Equation of Accounts, and Account Current adequately cover this phase of commercial arithmetic. New in this edition is the timely subject of Payroll Records and Procedures and a chapter on Business Insurance. General business problems are covered in chapters on Storage, Inventories, Gross Profit Computations, Analysis of Statements, Partnership, Goodwill, and Business Finance. Public Finance and Taxation deals with both individual and business taxes. Simple, useful principles of algebra are presented in the chapter on Fundamentals of Algebra and made use of in the chapter on Equations in which practical business problems requiring algebraic solution are presented. The use of logarithms and logarithm tables is very well presented in a chapter which includes a clear explanation of the simple slide rule. Chapters on Graphs and Index Numbers, Progression, and Foreign Exchange round out Part One.

Compound Interest, Ordinary Annuities, Special Annuities, Bond and Bond Interest Valuation, Asset Valuation Accounts, and Building and Loan Associations present the complete basic theory of compound interest and the application of compound interest methods to all types of business problems. New in this edition are chapters on Permutations and Combinations, Probability, and Probability and Mortality in which brief but significant treatment permits the inclusion of the further topics in acturial science: Life Annuities; Net Premiums; Valuation of Life Insurance Policies. Appendices present: a chapter on Practical Business Measurements, with problems; Tables of Weights, Measures, and Values; Loga-

rithm, Compound Interest, Annuity, and Mortality Tables.

Beside being a clear and comprehensive text-book this work is eminently useful as a reference handbook because of good indexing and the presentation of formulas and methods with ample illustrations for each topic covered, with a minimum of dependence on preliminary material. For anyone seeking a text to use in learning or relearning his practical mathematics, and to anyone needing a dependable book for reference, this work is recommended as one of the best obtainable.

RUSSELL D. LOUCKS

The School of Business and
Civic Administration,
The City College of New York.

Auditing Procedure (Third Edition), By DeWitt C. Eggleston. JOHN WILEY & SONS, INC., New York, 1947. x + 438 pages, $5.50.

This book is a good guide for the practitioner—whether he is of the junior grade or a principal. The junior will find material to assist in his training. The principal can refresh his memory when preparing an outline for an audit. The volume has numerous illustrations of working papers. A large number of these papers bring out the data which may be prepared when errors are noted. The chapters which discuss the verifications of balance sheet items and of revenue and expense accounts contain sections of programs of audit relating to the verifications covered in each chapter. These programs should be valuable aids to the practitioner in determining the extent of the verification to be made. The Review Questions at the end of each Chapter should assist the reader in deciding whether the subject matter has been digested. The chapters on Reports give detailed information on the preparation of Statements and Reports. These chapters illustrate reports which might be submitted in the following instances; Book Publishing Business—Manufacturer, Interim Audit—Manufacturer, Annual Report—Department Store, Annual Report. At the end of the volume there are 152 questions which are stated to be based upon practical experience. The practitioner will find this book very informative and helpful in his daily work.

PAUL E. BACAS

Bacas, Gates & Potter
New York, N. Y.

Standardized Audit Working Papers, By Frederick Staples, COUNTING HOUSE PUBLISHING CO., Milwaukee Wisc. 1947. 272 pages, $4.50.

This book is valuable primarily as a manual for users of the standardized audit working papers published by The Accredited Forms Co., Milwaukee, Wisconsin. In the preface the author states his objective as follows:

> "This book has been written to promote discussion among practicing accountants regarding the practicability of standardized audit working papers and their value in further improving the quality of the work done by the average practicing accountant, and as a text book for the student in accounting who seldom has the privilege of seeing a typical set of audit working papers covering an ordinary audit engagement."

The books consists of six chapters of text (104 pages) and three appendices containing (1) a complete set of filled in standardized audit working papers, (2) detailed audit report, and (3) interim report. The detailed audit report and the interim report are both based on the data contained in the filled-in standardized audit working papers.

The author discusses the desirability of the use of standardized audit working papers; special phases of, and innovations possible with them; special instructions where the data required are for the preparation of income tax returns only; and instructions in connection with an examination covering more than one year. Many accountants will find the chapter entitled "General Auditing Instructions (Manual)"

(Chapter III) of particular interest. As its title indicates, this chapter enumerates some general instructions commonly given to staff members by public accounting firms through the medium of a staff manual.

The illustrated standardized audit working papers contain all of the necessary working sheets for conducting an annual audit of a medium-sized company including the various requests for confirmation and the certificates to be obtained from management. Unfortunately, they have been reduced to approximately 60% of their actual size; in many instances this makes the reading rather difficult.

Though many arguments may be advanced against the use of standardized audit working papers, the subject is one which deserves consideration by practicing accountants. Mr. Staples ably presents the case in favor of their use. Even those who feel that standardization leads to inflexibility will find many of the forms well designed for general use.

BENJAMIN NEUWIRTH
Klein, Hinds & Finke
New York, N. Y.

Your Income Tax

(new 1948 edition for preparing 1947 tax returns), by J. K. Lasser, SIMON AND SCHUSTER, New York, N. Y., 1946. 168 pages. $1.00.

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